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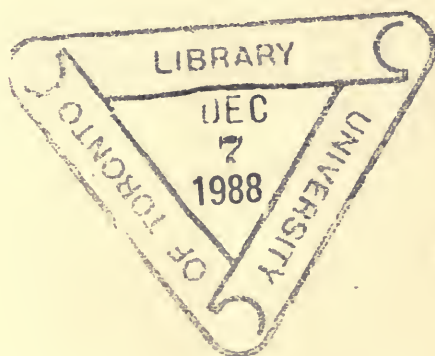
THE JOURNAL OF ACCOUNTANCY

VOL. XXXIV
JULY, 1922—DECEMBER, 1922

NEW YORK
THE JOURNAL OF ACCOUNTANCY, INCORPORATED
135 CEDAR STREET

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THE JOURNAL OF ACCOUNTANCY, INCORPORATED

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The JOURNAL *of* ACCOUNTANCY

Official Organ of the AMERICAN INSTITUTE OF ACCOUNTANTS

Vol. 34

JULY, 1922

No. 1

Present-day Problems in Industrial Accounting*

By STANLEY G. H. FITCH

The title adopted for insertion in the printed announcement of this meeting prior to the preparation of this paper purposely allowed wide latitude in the scope and treatment of the subject. Furthermore, at an informal summer meeting, I hope I may not be held to a too strict accountability if some of my remarks should prove to be somewhat irrelevant to the subject.

In selecting for discussion some of the many present-day problems in industrial accounting, I found it difficult to decide what problems were of first importance, because so many questions are continually arising in daily practice which at the instant seem to hold the centre of interest.

Broadly speaking, most accounting problems which we have to solve may be viewed from the standpoint of the balance-sheet. It may be argued that questions relating to the profit-and-loss statement should be separately grouped, but, after all, any transaction affecting the profits necessarily affects also some balance-sheet item, either an asset or a liability, so that for the purposes of this paper I propose in general to adhere to the balance-sheet as the base from which to approach the problems which I have selected for discussion, out of a great many which might have been chosen.

The balance-sheet itself as to form and arrangement presents at once a problem of paramount importance, and in developing the subject we might naturally proceed to take up questions relating to the treatment of the several balance-sheet groups. Some may be wondering how such a treatment of the balance-sheet is going very far toward the discussion of problems in industrial account-

*An address delivered at the fourth New England regional meeting of the American Institute of Accountants at Boston, Massachusetts, June 5, 1922.

ting, so here I might say that cost accounting, a highly important branch of industrial accounting, involving the application of overhead expense to the cost of product, has a direct effect upon the subject of inventory valuation, which brings us back at once to the balance-sheet. This topic will receive further attention later in this article.

FORM OF BALANCE-SHEET

Much has been written on the subject of a standard form of balance-sheet, but a casual reference to a few forms prepared by banks and bankers, which have been selected at random, discloses a striking lack of uniformity among those commonly used.

I should like to put the following question: In submitting a certified balance-sheet should the accountant follow the form prescribed by the client's bank or by the broker who handles his paper, or should he adopt a form of his own, which in his judgment, owing to the peculiar circumstances of the case, sets forth clearly the client's financial condition, with particular emphasis upon certain outstanding features disclosed by the audit?

I do not propose to answer that question, but for the purpose of laying the foundation for discussion, which I hope will follow, I shall mention some of the significant variations in three selected balance-sheet forms, designated for convenience as "A", "B" and "C".

Current Assets:

Balance-sheet "A" classifies as current assets, cash, notes and accounts receivable, inventories, quickly marketable securities and notes and accounts due from officers, stockholders and employees. Balance-sheets "B" and "C" include as current all of the foregoing assets except notes and accounts receivable from officers, stockholders and employees. Such items in many instances may be slow in realization, but in the other cases they may be quick assets and, for the purpose of setting forth the assets available for meeting current liabilities, they should be included under those conditions as current assets.

Balance-sheets "A" and "B" make no provision for subdividing the asset items for notes, accounts receivable, merchandise or securities, so as to show what has been pledged as security for loans, while balance-sheet "C" assembles in a separate group all pledged current assets (notes and accounts receivable, acceptances, merchandise and securities). This arrangement shows at a glance

the total amount of such assets pledged but, on the other hand, makes it impossible without recasting the balance-sheet to state the total amount of each asset, pledged and unpledged. Balance-sheet "A" very properly indicates that reserves for bad debts, discounts, allowances, etc., should be deducted from the asset, while balance-sheets "B" and "C" provide for reserves upon the liability side of the balance-sheet. Inasmuch as the purpose of the balance-sheet is to show the net amount likely to be realized from the liquidation of any current asset, the former method is to be preferred.

Balance-sheet "A" does not provide, however, for a separate classification of notes and accounts due from controlled or subsidiary concerns, and, while such a subdivision is made on balance-sheets "B" and "C," the items are not classified as current assets. It may be pertinent to remark, however, that a scrutiny of the balance-sheets of the subsidiaries might disclose that the balances due the parent company were offset almost wholly by current accounts and notes receivable from customers, so that in reality the balances due from the subsidiaries on the parent company's books actually represent assets more "current" from the standpoint of quick realization in cash than inventories classified as current assets on the balance-sheet forms in question.

Current Liabilities:

All three balance-sheets ("A," "B" and "C") include as current liabilities notes payable, accounts payable and accrued items (taxes, interest, etc.), while on balance-sheets "B" and "C" are set forth as separate items dividends declared and payable. Balance-sheets "A" and "B" clearly indicate the separation of notes payable as unsecured and secured respectively, but the amounts are grouped so as to show the total notes payable, while balance-sheet "C" shows notes payable, secured by notes receivable, accounts receivable, trade acceptances, merchandise and securities as a separate group. This arrangement is open to the same criticism as applied to the relative pledged assets: that it does not disclose at first glance the aggregate of an important liability, viz., notes payable, including both unsecured and secured notes.

It is worthy of note also that in balance-sheets "B" and "C," notes and accounts payable to controlled or subsidiary concerns are included in current liabilities, while, as previously mentioned, notes and accounts receivable of similar concerns are excluded

from current assets. If such accounts and notes payable by the parent company to the subsidiaries represent deferred liabilities, they can properly be excluded from the current liability classification.

Fixed Assets:

While the three balance-sheets under discussion differ as to degree of detail in stating the fixed assets, there are two important variations calling for comment: first, balance-sheet "A" provides for the deduction from the fixed assets of the reserve for depreciation, while balance-sheets "B" and "C" indicate no such application of depreciation reserves in reduction of the respective assets but show the reserves on the liability side of the balance-sheet. The former method is to be preferred in that it shows at once the net book value of the fixed assets and precludes the inclusion of the reserves with surplus. Secondly, on balance-sheet "A" goodwill is deducted from the total of capital stock and surplus in stating net worth, while on balance-sheets "B" and "C" goodwill is shown in the usual way on the asset side of the balance-sheet. In some circumstances, where goodwill is carried at an inflated value, the former method would no doubt be justifiable, but in other cases, where goodwill has a clearly demonstrated value, the virtual writing off of the goodwill value would be far from a correct procedure.

Other comparisons could be drawn from the balance-sheet forms under discussion, but enough has been said to show clearly the need for further development toward standardization.

I might add that the balance-sheet forms selected for comparison could in no way be classed as freaks; they were issued by three leading banks. If any attempt had been made to analyze the variations in form shown by some less carefully prepared balance-sheets, even more striking inconsistencies would have been disclosed.

I believe that public accountants and bankers both realize the advantages that would accrue to all parties at interest if a form of balance-sheet could be evolved which would be accepted generally as standard. An interesting announcement appeared in the bulletin of the American Institute of Accountants, dated May 15, 1922, to the effect that a committee of the Robert Morris Associates (an organization of credit-men of banks) was recently appointed to investigate the question of closer coöperation with

public accountants. This was followed by the appointment of a committee of the American Institute to meet and act with the representatives of the Robert Morris Associates. I venture to express the hope that one result of the contemplated joint work of the two committees may be some contribution toward the standardization of balance-sheets.

VALUATION OF INVENTORIES

The valuation of the inventory at the balance-sheet date determines to a great extent the profit or loss for the prior fiscal period and the financial condition at the close. Consequently, the inventory is rightly subject to close scrutiny on the part of those concerned in granting credit on the basis of the balance-sheet submitted.

Some of the questions usually asked are these:

Was a physical inventory taken or does the inventory reported represent a book balance with or without supporting perpetual inventory records?

If a physical inventory was taken, did the auditor assist in or supervise the actual counting, weighing and listing of the stock?

How was the inventory valued, i.e., at cost or at cost or market whichever was lower?

How were cost values and market values ascertained and does the company operate a cost system?

Were the calculations and footings carefully checked to obviate clerical errors, which, while unintentional, have the same effect as deliberate falsification of the inventory?

And, finally, to what extent did the auditor verify the work of the client's force, and how far is he responsible for the value reported?

The manner in which the inventory is shown on the balance-sheet, in conjunction with the auditor's certificate thereto, should be a satisfactory answer to the last question.

COST ACCOUNTS IN RELATION TO INVENTORIES

I cannot, however, dismiss the inventory problem without some particular reference to cost accounting in its relation to inventory valuation. We all admit that in ascertaining costs, an allowance for overhead should be included and opinion is fairly unanimous that overhead so included should be limited to that relating to manufacturing or production, as distinct from selling and general expenses. But in times of depression, overhead costs soar, while

the increase in direct costs is relatively small. In the case of merchandise manufactured under such conditions, should it be inventoried at actual cost, which means virtually the absorption of losses directly attributable to idle capacity?

Aside from the accounting aspect of the case, what is the effect on the balance-sheet offered for credit purposes? Balance-sheets of borrowers are now perhaps more than ever before subject to searching scrutiny by bankers and credit-men, and in a great number of cases their attention is focused upon the inventory as the key to the borrower's financial condition. The familiar phrase describing the valuation of the inventory as "cost or market whichever is lower" may possess special significance. What does "cost" mean, especially with reference to finished product manufactured when production is far below normal? Does "cost" mean that actual overhead charges have been loaded upon the merchandise, thereby inflating the book value by inclusion of unearned overhead which should have been charged to profit-and-loss? Is it truthful to say "merchandise is valued at cost," when in effect the inventory includes deferred charges to profit-and-loss, which should have been written off in the period just closed, instead of being carried forward as a burden to be taken up in the ensuing periods?

The answer is "No." In my opinion the solution is the use of normal or standard costs for inventory valuations. Then the merchandise can be fairly valued and the loss arising from idle plant can be ascertained and intelligently treated.

Obviously the only fair cost to use in the valuation of an inventory is a normal or standard cost. If that basis has been used, supported by details drawn from the cost records, the borrower will be in a strong position to maintain his credit with his banker, while if the other basis has been used, i.e., inflated values arising from excessive overhead in costs, the credit-man's mind is at once charged with doubt as to the soundness of the borrower's balance-sheet.

INCLUSION OF INTEREST ON CAPITAL IN COST, AND THE EFFECT ON INVENTORY VALUES

I do not propose to start any argument as to whether or not interest on capital should be included in costs, but to point to a practical difficulty which is encountered when such interest is included in costs. By interest on capital, I mean interest com-

puted on capital invested in the assets employed by a manufacturing plant, which is charged to manufacturing costs and credited to income or to profit-and-loss; in other words, an imaginary transaction and not an actual outlay.

In the operation of a highly developed cost system, which recognizes interest on capital as an element of cost, it is customary to allocate to each manufacturing department its proportion of such interest and to include that interest in the departmental overhead which is distributed to production centres or to individual machines. Such overhead (including interest) is absorbed in the cost of the product which passes through the several departments. Consequently, if we take as an example a finished machine, the product of a textile machinery plant, the cost is represented by the aggregate of the costs of a multiplicity of parts, made in different departments, including a proportion of the charges for interest on capital allotted to the respective departments but merged with other overhead charges.

If the interest charge is allowed to remain in the cost of that machine for inventory purposes, we have an inflated value arising from the inclusion of an unrealized profit. That truth, I believe, is generally recognized by the proponents as well as the opponents of interest as an element of cost. In arriving at a proper inventory basis there remains, then, only one further step, and that is to eliminate the interest from the cost of the finished product. That sounds very simple, but actually it is practically impossible, because the identity of the interest charges has been lost in the distribution of the overhead, and the process can be reversed only with extreme difficulty. I have seen detailed instructions, accompanying most excellent cost systems, for the inclusion of interest in cost, but I have never seen similar detailed instructions for the elimination of said interest from the cost of the finished product, if such be required.

PURCHASE COMMITMENTS FOR FUTURE DELIVERY

Recently many losses entailed in deflating inventory values were recognized and taken into account in preparing annual balance-sheets, but other similar losses arising from purchase-contract commitments for future delivery could only be approximated.

During the period of deflation in commodity prices, through which we have just passed, great stress was rightly laid upon the

borrower's purchase commitments and their probable effect upon his ability to meet his obligations or perhaps even his prospects of continuing in business. In order to obtain supplies of materials it was necessary to make purchase contracts, and in a period of falling prices losses were in many cases unavoidable. Bankers justly required full information bearing upon the borrower's liabilities of that nature.

With the return to a period of stable prices, losses on commitments become less a cause for anxiety. We as accountants face the problem as to what extent we shall inquire into and report upon purchase commitments which are made in the ordinary course of business. One banker expressed the opinion that he was not interested in contracts made under such conditions; but others held opposite views.

OBLIGATIONS OF THE AUDITOR UNDER BOND INDENTURES,
CAPITAL STOCK ISSUES, ETC,

The public accountant must always be on the alert for clauses in bond indentures and capital-stock certificates, which delegate to him definite responsibilities. Certified statements are frequently required under such conditions, but a study of the documents may develop the need for a legal interpretation of the meaning of a clause which may be construed in more than one way. Whose advice shall the auditor take in order to meet his responsibilities intelligently and properly?

In one case recently under consideration the definition of "quick assets" required careful interpretation. In another case the basis of the inventory valuation, as set forth in the indenture, could be construed in more than one way. In a third case the auditor was charged with the responsibility of determining what constituted "adequate" depreciation before certifying the profits available for dividends, and in a lean year he was forced to take issue with the corporation officers. The foregoing illustrations demonstrate the need that the auditor inform himself as to what his responsibilities are before he affixes his signature to a certificate.

FORM OF BALANCE-SHEET CERTIFICATE

A serious problem which I believe we shall always have to face is the use of the qualified certificate. The ideal conditions leading up to an unqualified certificate cannot always be realized. But the practice of issuing a statement which is merely a con-

densed copy of a trial balance, with a certificate stating in effect that the balances agree with the books and have not been otherwise verified, should in my opinion be discouraged, not because the accountant says he has done anything which he has not done, but because of the failure of many bankers and business men to read the certificate and to understand its significance. They see merely a balance-sheet statement over the auditor's signature and assume that it is an audited statement.

Not long ago, a banker expressed himself as unable to understand why a certain corporation had gone into the hands of a receiver within three months after issuing a satisfactory statement of condition over an auditor's certificate. Upon inquiry as to the form of certificate, the statement was produced which showed a "certificate" to the effect that the statement was only a condensed copy of the trial balance and that no audit whatever had been made. The fact was that the banker either did not read the certificate or did not realize its significance.

Our hope for a greater opportunity for service lies in educational propaganda to the end that the business community may realize more fully the value of the accountant's work and the importance of reading what the accountant states over his signature.

CONFLICT BETWEEN ESTABLISHED ACCOUNTING PROCEDURE AND FEDERAL TAX REGULATIONS

A problem which is only indirectly related to the balance-sheet is the conflict between established accounting procedure and federal tax regulations.

Many of us have frequently been asked by clients for counsel as to the advisability of adjusting their books to conform to the results of audits of tax returns according to federal tax regulations. Charges for depreciation and repairs have been a constant cause of dispute between the taxpayer and the treasury department, resulting in disallowances of such charges in many cases. Should the asset account, surplus account and depreciation reserve account then be adjusted upon the books? Obviously the bookkeeping would be simplified for future years by maintaining only one set of accounts, without the necessity of reconciling annually the figures shown by the books with those shown by the tax returns. On the other hand established bookkeeping procedure,

adopted for valid business reasons, would thereby be upset and valuable comparisons rendered impossible.

One client who adopted the "cost or market" basis for his inventory decided to abandon the "cost" basis for bookkeeping, although that basis had been followed for years. He soon found, however, that to operate his cost system using cost or market was a complicated matter. The solution seems to me to be to keep the accounts on a cost basis and to make annual adjustments in the aggregate if it is desired to bring the accounts finally to a basis of "cost or market."

Auditors I Have Known

By MABEL D. PAINE

A well-known book on accounting tells us, "The accountant is a judge to whom appeals are made by the employer against the employee. . . . Bookkeepers are generally interested only in methods and devices which save them personal effort; they are apt to forget that they were not engaged to make their work easy, but to keep books in such a manner as to make them valuable to the employer." This statement drew a little gasp of surprise from one who, lacking wide or definite knowledge of the subject, had yet entertained a vague idea that bookkeepers were, on the whole, rather a hard-working and conscientious lot. That the public accountant may view them from a different angle is suggested by the author's further words: "Accounting . . . must war incessantly against carelessness, ignorance, inefficiency, evil-disposed cleverness and, possibly, against dishonesty." From a bookkeeper's point of view this sounds rather harsh, but it is plain that if all books of account were honestly and accurately kept, one of the prime causes for auditing would be non-existent.

Consideration of these different points of view raises two interesting questions: first, When (if ever) is a bookkeeper also an accountant? Accountancy seems to be the popular profession of the day. Doubtless the original impetus toward this popularity was given by the increasing complexity of the income and profits-tax return, for many an individual has thereby been driven to a knowledge of accounting terminology and methods which he would not otherwise have acquired; and the number of those who are "taking a course in accounting" is legion. A demonstrator of a widely-used calculating machine, commenting upon the fact that "this accounting is the thing nowadays," went on to say that he would very much like to secure a C. P. A. degree, that he might be prepared to show just how the machine could be made most useful in each individual business. He apparently thought that by devoting to this object one or two evenings a week, the desired end could be attained in the course of a season—a view which might be justified by the advertisements one reads, offering rich rewards in the field of accountancy to those who are willing to give up a little leisure time to the study. It is perhaps a logical sequence to these accounting courses that so many now advertise

their qualifications for the position of "bookkeeper and accountant." Clearly, the man whose bookkeeping is limited to handling the A to K sales ledger, and whose practical knowledge does not exceed the requirements of that work, has no claim to the name of accountant; but what *does* constitute a private accountant?

For the other question—while a *bookkeeper* realizes quite poignantly that he is "known by his doings" to the auditor who goes over his accounts and that those accounts reveal much concerning his methods of work and himself, does the *auditor* in turn know that the process of appraisal is two-edged? For instance, one is aware that a capable auditor does not require the entire set of books at his elbow throughout the period of the audit; that it is far easier and more comfortable to be audited by a "first-class man" than by one of indifferent qualifications; that an accountant who is well-read and has had valuable experience does not try to impress that fact upon one, knowing perhaps that such qualities or attainments speak for themselves. Where the undertaking is so large that many auditors and many bookkeepers are concerned, the work must of necessity be more impersonal, offering less opportunity for individual observation. In all probability, the auditor would consider a bookkeeper's opinion a matter of negligible importance in any case, for one is sometimes tempted to believe that they look upon books of account as having been created for the purpose of being audited, while the bookkeeper, like the bridegroom at a wedding, is a rather essential but otherwise unimportant adjunct.

If a bookkeeper's experience has been such that he looks upon auditors as militant judges, set over him to ferret out possible misdeeds and to pass sentence upon him, then his opinions might very probably make rather lurid reading; but when one first comes into charge of a full set of books and at the same time learns that those books will be audited periodically, the chief feeling is one of curiosity, especially when the bookkeeper knows only enough to realize how infinitely much more there is to be known. Through years of audited work, one grows to be not only tolerant of the vagaries of these bothersome auditors, but grateful for their help; to study them with friendly interest; and even to cherish a certain wistful admiration for some acquaintances who have helped to bring accountancy into dignity as a profession and have made good in that profession—an achieve-

ment the more noteworthy because the accountant must build up his clientele largely from the ranks of business men and manufacturers, who have been prone to look upon accounting as an elaborated form of hairsplitting, scarcely worthy the consideration of a red-blooded man. But they are beginning to realize that it requires for true success broad knowledge and experience, not only of accounting itself, but of commercial law, of industrial conditions, of finance and, last but not least, of human nature.

Back in the days when income taxes had not yet appeared on the business horizon and when accounting practice had received scant notice at the hands of the legislature, an "expert accountant" of wide experience and a very green would-be bookkeeper formed an alliance which lasted over a dozen years and terminated only with the death of the accountant. The adjective "expert" is not quoted from himself but seemed to be more frequently used then than now to designate a public accountant. He had been asked to recommend improvements in the system and it now seems odd that the following suggestion should have represented a decided innovation to those interested in the books: "All cash receipts should be deposited in a bank and all payments for cash should be made by cheque and the cashbook so ruled that the discounts . . . should be placed in a column immediately to the left of the cash; . . . to provide for sundry small cash payments, a petty cash account to be kept entirely separate and singular," etc. Although there have been many changes and revisions since that first report was received and the work has increased in volume so that one pair of hands is no longer equal to the task, the cashbook more than any other remains the same in essentials. Had this petty cash fund been given the name now usually attached to it, that bookkeeper would not, in later years, have said to a very learned accountant, "But I know so little! Now, for instance, someone was talking the other day about an 'imprest account'." "Well," was the answer, "you know what that is." "Why, I never even heard of it!" A look of amusement flashed into the keen eyes as he retorted, "Nevertheless, you have been carrying one for a good many years." Suffice it to say that one bookkeeper thereupon set to work to learn a little bit more about accounts in general.

At the beginning of his association with the business in question, the first auditor was not a C. P. A., for the very good reason

that no such degree had ever been created in the state. When the law was enacted he entered the opening examination with some trepidation, for examinations are doubly nerve-wracking when many years have elapsed since one has undergone the experience, but emerged with flying colors and an almost boyish satisfaction that the thing was well over, which it was good to see. One quality that enhanced his helpfulness, indeed, was his humanness. Accounts may be well and thoroughly checked on an absolutely impersonal basis, but if helpful service is to be part of the work, a bit of friendly interest is a great addition.

To each auditor who has appeared often enough to impress his image on an active memory, certain characteristics appertain; out of all that might have been remembered of this first service, two little details seem to stand out disproportionately to their importance. His material equipment was unfailingly complete and yielded fountain pens for both red and black ink, a miniature stamp and pad, pencils, erasers, even a ruler. One hastens to add that such small necessities would have been most willingly supplied, and yet the forethought that provided for even the least detail commanded respect. Also, it was his habit to make very neat and tiny check-marks! It is an absurdly small thing to remember so long, nor is he the only one of whom this might be said; but apparently an occasional auditor thinks fat red check-marks should be considered an ornament. One memory that brings a smile now relates to an auditor who devised and carried out a scheme for placing check-marks between the dollars and cents columns throughout the general ledger, right in the middle of each amount. Under this treatment, the familiar columns took on an oddly disconcerting appearance; the bookkeeper hoisted signals of distress, only to be informed that there was a reason for it. Since, however, the checker did not state that it was required "by the best accounting practice" or that it was "the proper procedure" (under either dictum a well-trained bookkeeper promptly wilts) the check-marks thereafter resumed their usual location. On the other hand, a carefully prepared list of insurance policies, submitted for verification, was returned by the accountant-in-charge, checked with infinitesimal dots, because he had thought it a pity to mark up so neat a schedule—another trifling thing—but the thoughtful consideration was no trifle, and if a man's ability as an accountant is augmented by such qualities as

tact, courtesy and appreciation of the other fellow's side, it must surely make him more successful and helpful.

Undoubtedly some of the devices which a bookkeeper works out to take care of special needs may appear very unconventional, even funny, to the auditor. Books on accounting do not always supply wanted information in an emergency. It is strange, however, to meet later in good accounting society some pet scheme fancied to be peculiarly one's own. Eager with a new plan, the bookkeeper one day said to the first auditor: "Why wouldn't it be a good idea to have a journal with columns arranged after *this* fashion?" "It would be excellent," was the laughing reply, "but a man invented that form of journal before you were born!" The writer is even now awaiting with some curiosity the auditors' opinion of a brand-new (?) arrangement for a rather bothersome account. Will they say, "Oh yes, that is often done"; or will the comment be, "I never saw that handled in such a manner," with a doubtful expression which conveys the opinion that it never *should* be so managed? At the risk of appearing over-sanguine, would it be impossible for a bookkeeper to devise some little scheme which, although it had not the sanction of precedent and convention, was yet good in itself? Have all the ideas been already developed?

To fall into the hands of a large accounting firm, after so long an association with one auditor, brings many changes. The bookkeeper looked up one day to behold an imposing procession advancing. Leading the way came "the chief," followed, in due order of precedence, by the principal accountant, senior and junior assistants. They were irresistibly suggestive of the Belvidere Male Quartette about to line up and break forth into song, and the waiting victim sternly repressed a chuckle. Three able-bodied men to audit the accounts of one harmless bookkeeper? The said bookkeeper's ignorance of customs in an accountant's office was so comprehensive that such terms as resident partner, senior and junior assistants and the like were then unfamiliar; but it soon became apparent that only two might be expected to remain.

It was natural that in taking up the work, this firm should hold some theories quite different from those prevailing before; natural, also, that a bookkeeper accustomed to one accountant's ideas should find it a little difficult to accept at once anything

quite radically different; and so there arose an amicable but earnest argument as to the accrual of taxes—income taxes of a mild and simple nature having by this time arrived on the scene of action. This was another trifle, surely, to linger in one's mind, but the discussion closed by the auditor's saying, not with any air of superiority but in friendly fashion, "Well, anyway, you just think it over"; and sure enough, after the matter had been thought out, his conclusions seemed altogether reasonable. It would have been so easy to press the point in a way that would have offended instead of convinced.

That assistant-in-charge was a most courteous and kindly auditor and so good an accountant as well that all too soon (from one point of view) he advanced to larger undertakings, "gone, but not forgotten." Variety may be the spice of life, but as exemplified in auditors it contains elements of discomfort. So many have come and gone since then that they almost blend into a composite portrait with the light striking here and there on some marked feature; and be it said in all sincerity that the most pronounced feature is courtesy, differently shown but always present. Almost as generally characteristic are tact and kindness. Although it might be thought that the two are synonymous, there is really a difference. For instance, it could not be reckoned the most fortunate way of introducing the subject for an auditor to say abruptly, "There is a lot of errors on this sheet," and that in a case where the figures had been prepared, checked and rechecked with meticulous care. The event proved that there were no errors, except in his method of handling or conception of the work; but no one felt even the slightest offense, because he had been uniformly kind, even though his tact may have failed now and then. Everyone knows the uneasy feeling induced by a dentist who probes here and there, asking, "Does that hurt? Is that sensitive?" seemingly just looking for trouble. Somewhat the same mental state results when an auditor appears really *eager* to find errors; but in truth such auditors have been exceedingly rare in the writer's experience. Perhaps, as an attorney remarked concerning the auditors of federal tax returns, "They feel they must find something incorrect, to justify their existence." One trait which has been almost universal among those who have worked in this particular office is a cheerful willingness to accommodate themselves to physical conditions, when for some

reason the client has been unable to provide exactly the ideal place for them. If the heating plant is temporarily out of commission and a cold wave makes itself felt when warm weather should naturally be prevailing, they blithely remark that it was much colder in France and proceed undaunted with the audit. In fact, as a general thing, they seem oblivious of the surroundings and intent only on the work in hand.

Certain phases of an audit are a wee bit trying, even when the auditor is well-liked and the bookkeeper habituated. One accountant says that some people feel insulted at having their cash verified and it is true that on hearing for the first time, "Shall I count your cash now?" a still small voice somewhere in one's inner consciousness instantly responds, "You let my cash alone!" but that feeling soon vanishes. Affairs did look rather bad for the keeper of the cash when an attempted embezzlement (?) of fifty cents was brought to light and had to be acknowledged. Since it was the first offense, restitution was accepted as covering the crime and no mention was made in the report. Happily, the auditor who then called attention to a shortage was not the one who carefully unrolled all the nicely-wrapped currency in the drawer, in order to make a thorough count. Possibly it was only the cashier's lack of knowledge that made this seem a novelty; but if it is required by the proper procedure, it has never but that once come to notice.

It soon becomes natural to turn over for verification purposes everything connected with the accounts. Obviously, no accountant can certify to that which he has not actually seen; and it is odd that the only request which awakens the faintest shade of protest in one bookkeeper's mind is the call for current invoices, to be used in proving that no bills have been feloniously held back. After laboring strenuously to take up every liability before closing, one seems to feel a special element of suspicion in that demand. The search sometimes brings amusing results, as when a young accountant apologetically remarked that provision had not been made for a small contract. The service contract in question involved an annual amount of sixty dollars, paid in quarterly instalments, and he felt that, strictly speaking, the expense for two months and a half should have been accrued before closing. It was a pleasure to be able to assure him that, inasmuch as the quarterly amounts were payable in advance, there

was really a prepayment of one-half month, although it had not been carried on.

What can one do when an accountant voices a most heterodox theory, declaring that his firm always bases its practice on that principle; when not even the bookkeeper's previous experience with the firm nor statements in *Regulations 45* nor any other argument will convince him of the error of his ways? The one time that this happened must have been due to temporary aberration, but left a marked impression on the hearer's mind. It remained for his chief to set him right. Any bookkeeper would be extremely foolish to feel elated over being found in the right when a question comes up, but he would be more than human if it were not a satisfaction, for it must be sadly confessed that bookkeepers are not infallible and the victim does wriggle most uncomfortably when confronted by the auditor with some error that has crept in, despite careful work. It is a comfort to find that Jove may nod occasionally. Anyway, an infallible person would be a terrible bore, and how would the auditors derive any satisfaction from their work if everything were found at a dead level of perfection? As one man feelingly remarked, "This constant checking pretty nearly puts me to sleep"; and another, "It's no fun checking books that have no mistakes." (He happened upon a lucky period when everything went right.) When an auditor intimates that the work lacks interest because it is all so "cut and dried," it awakens a mischievous desire to do something next time which, perfectly correct in itself, shall nevertheless set that accountant to guessing.

It is of course impossible for even a very good accountant to be familiar with terms and processes peculiar to every line of business where his lot may fall, but it arouses a queer little feeling of surprise when a man who knows so much betrays absolute ignorance of some matter which is as A B C to the bookkeeper. It happened one day that an auditor, about to check an inventory which included much paper stock, inquired the number of sheets in a ream. That was not strange—it is so easy to forget details not in constant use—and the answer was prompt, "Five hundred to the commercial ream." Then, "How many quires are there?"—which was also natural enough; but why, having learned that "twenty quires make one ream," should he ponder the matter for a moment and then propound a third question, "Well, how many

sheets are there in a quire?" Or again, what difference could it make in the final result of an inventory of work in process, whether one reduced the accumulated minutes to hours at the bottom of each sheet or at the close? Why wait until the end, anyway, since the other method gives smaller amounts to handle? And when an auditor says in dignified manner that he "computed in a different way" a small technical problem that could have but one correct answer, why, one is curious as to how he could possibly do it, to reach a different result.

A sense of humor is a most desirable attribute in an accountant. Without it (and this is said with the utmost diffidence), is there not a little danger of an over-serious conception of the work? Imagination winces at the thought of what might have happened to the luckless wight in the following incident, had not the accountant, who justly enjoys a reputation as an authority in his chosen line, been gifted with that most helpful quality. Talking of a certain account, rather difficult to handle at first acquaintance, and unconsciously rushing in where angels might have feared to tread, the bookkeeper said, "Yes, I think I grasp its functions now; but it seems to me that treatise did not make it as clear as it might have done." Then, out of some vague memory, a dreadful thought took shape; surely his name had been connected with that work? "Did *you* write that?" And it proved to be even so. How the author might have frozen that rash critic, had he not chosen to laugh instead!

In a recent conversation with another wise accountant already mentioned, some question arose regarding general expense. "Well, for instance," he was asked, "wouldn't you class the auditor's fee as an indirect or general expense?" "Very general indeed," he replied, with a twinkle; "you might charge it up as a necessary or unnecessary evil, according to your point of view." Then and there it quite suddenly dawned upon his hearer with a little shock of astonishment that if it were possible to become an un-audited bookkeeper by simply expressing a desire, no such wish would ever be uttered; for, after all, there is a certain security and satisfaction in knowing that one's work has been weighed in the balance and not found wanting in essentials; and the bookkeeper who honestly wishes to do the very best and most valuable work possible has nothing to fear from "those auditors."

Accountant and Banker*

By SPENCER S. MARSH

To James G. Cannon of the old Fourth National bank in New York should be given the credit for having first created among bankers a desire to have their commercial loans supported by signed statements from the borrowers, showing their financial condition.

For many years bankers had been in the habit of granting loans to their customers, basing them entirely on the character of the borrower and the meagre knowledge of his business that could be gained from the way he conducted his bank account. This method of determining whether a loan was desirable or not was most unscientific and resulted in creating a wrong attitude on the part of the borrower toward the banker, in many cases giving the borrower a false sense of being injured when asked to furnish a statement of his affairs or questioned too minutely concerning his business.

Through the efforts of a group of men, among them Mr. Cannon, bankers in this country were led to see that they were entitled to statements from their borrowers, and gradually the borrowers were educated to a point where they could see that information given to their bankers was for their mutual good. Credit departments were organized in banks, their function being to keep careful and accurate records of all credit risks, securing statements from all borrowers at least annually, tabulating and analyzing the contents and translating the figures into a standard language that could be read quickly by the banks' officers.

The wisdom and vision of the men starting this movement is shown by one illustration. A large merchandising house of national reputation enjoyed the best of credit. Accounts were kept with several large New York banks. Banks all over the country purchased the paper of this house and its subsidiary companies in large volume from note brokers, taking the recommendation of its banks as to its worth.

The house became involved and failed. Nearly every bank in the country that was a purchaser of commercial paper held some of this paper and great surprise was expressed when it developed

*An address before the Society of Certified Public Accountants of the State of New Jersey.

that one of the large New York banks not only had none of the paper of the failed house, but had asked the concern to close the account formerly carried with it. When asked to explain the position in which this bank found itself, an officer answered simply: "Why, they would not give us a statement of their affairs and we will lend to no one unless he can and will support his application for a loan with a statement."

This experience had a great influence on banks throughout the country and probably did much to crystalize the opinion among bankers that unsecured commercial paper should always be supported by a statement. Before long dishonest merchants discovered that bankers could be fooled by false statements, and it was a natural suggestion that statements be made up by disinterested persons after an audit in a scientific manner.

This demand for accurate knowledge of a borrower's financial condition has grown until it is the general practice of the banks of the country to demand statements from borrowers and often to insist that these statements be made by independent persons. The result of continued education is shown by the willingness of dealers to supply statements and the large number of houses that now employ outside accountants to make regular audits and reports for the manager's own information and use.

Your president suggested that I discuss some of the points of contact between the banker and the certified public accountant. I shall take a liberal view of this text and in a general way try to tell you what a banker wants to know about a borrower and what he tries to get from the statement presented—whether it be made up by the borrower himself or by an accountant.

Better to understand the banker's point of view I think we should remind ourselves of several fundamental principles by which he is guided if he is true to his trust.

First: He is lending other people's money. He therefore wishes to surround his loan with the best scientific knowledge obtainable.

Second: It is the bank's function to supply credit, not capital.

Third: He must so guide his borrowers and limit his loans that his bank shall not become a partner in any business enterprise.

Fourth: This should perhaps have been first—he should base his loans on the *character*, *capacity* and *capital* of his borrower in this sequence. Any statements filed must help him to apply

these principles in determining whether or not the loan is to be granted.

I think that bankers generally want to coöperate with the accountant and would welcome some method of standardizing as nearly as practicable the reports of your audits. I realize that many difficulties must be surmounted before this can be accomplished, but if your principal is told that when your report is to be submitted to his bank as a basis for credit it must contain certain vital information, it may help to surmount some of these difficulties.

When the report of your audit is placed before the officer who is to pass on the loan his first interest will be in the description of the audit made by you—to determine its scope and thoroughness.

This in a general way should recite whether or not the business under review maintains a proper set of books—that show its condition at all times—whether or not these books are run properly and kept in balance. This applies particularly to medium and small concerns, although some large enterprises are subject to criticism in this respect. If the business needs a cost system—state whether accurate or only approximate. The banker will quickly pass to the figures showing assets and liabilities, particularly those showing the quick assets and current liabilities. To be most helpful these should be grouped to show the subtotals of each so that comparison can be made quickly to determine the ratio of current debts to quick assets. The banker is not interested so much in the slower assets and permanent debts as he is in the former figures, for in large measure his decision will be determined by the excess of quick assets over liabilities shown in the statement. While this is so the slow assets should be shown in detail and should be subject of comment. A borrower's ideas of what constitutes a current debt and the banker's idea of the same kind of debt do not always agree.

Then the operating or profit-and-loss statement should have close scrutiny and should show comparison with former years. The slow assets often contain items that vitally affect the firm's credit standing.

To illustrate: A statement showing some three hundred thousand dollars' worth of quick assets in excess of current liabilities had among its slow liabilities an item of \$350,000 that

looked and acted like a mortgage on its plant. Investigation showed that this item covered notes given by the corporation to its stockholders in payment of money advanced by them to purchase the plant, with an understanding between the stockholders and the corporation that the notes would not become due for ten years. Nothing was in evidence, however, that would prevent the holders of these notes from demanding payment at any time.

This item should have been included among the current liabilities. It put an entirely different complexion upon the cash position as shown by the statement, as the charge wiped out the entire quick assets and could have been remedied only had the holders of the notes placed their money at the risk of the business.

Items placed among the deferred debts should be supported by schedules that explain them completely.

Under existing conditions two asset factors are of the utmost importance to the banker—the inventory and the accounts receivable. During the past year numbers of bankers have realized that the oft-repeated accusation has become true—that bankers under the stress of circumstances had become merchandisers. They are vitally interested, therefore, in knowing all the details possible concerning the borrower's inventory—its volume; whether composed of finished goods; raw material on hand; method of determining the figures, whether estimated or appraised; and how carried, at cost or market values; amount of reserves set up for depreciation purposes.

The accounts receivable need careful attention because the banker looks upon them as a most liquid asset, usually the most capable among the assets of producing the cash quickly. The banker wants to know whether the amounts under this caption are all good, live accounts, what proportion are past due or for any other reason are uncollectible.

An item that is too often overlooked is a firm's contingent liabilities. These may consist of its endorsements on paper discounted, guarantees of accounts, forward contracts for material and any other liability that may be incurred and does not show on the face of the statement.

During the past year shrinkages in values of commodities have occurred that have placed thoroughly solvent concerns in a shaky position because of their inability satisfactorily to adjust contracts which existed before the shrinkage. Such contracts

have created contingent liabilities that rise up at the most unexpected times to "smite" the merchant or manufacturer with a most embarrassing demand for payment.

In a very general way I have mentioned items that seem of vital importance to the banker. There may be others that will occur to you. I feel sure that an organization of this kind can be of much benefit in using its influence toward placing the standard for its members so high that the banker or business man will know when he receives a report that it can be accepted without question.

J. P. Morgan said that the first consideration in any demand for credit that he was to consider was the character of the borrower. This must be true of the accountant. You are taken into the confidence and business secrets of the firm engaging you. You are to place before it a report of the business that may be responsible for a course of action which will either make or break the business. The report may be presented to your client's banker as a basis of credit. The client may even suggest to you that you prepare the report so that it will support an application for credit and be passed by a banker. Your position is very much that of a physician who is engaged to keep his patients well. Both the merchant and banker are depending upon your integrity and courage to show any business ill, that it may be corrected at once.

This calls for the highest sense of duty and obligation and means that your organization should not tolerate or condone any breach of the highest ethics.

The Cost Audit

By CLINTON W. BENNETT

Many of the difficulties that sometimes arise in obtaining expected results from a well-devised and installed cost system can be traced directly to faulty treating and supervising of the detail records. After the plan has been completely installed and its operation left to the client's force, conditions which are new to the staff are very likely to arise in the handling of the work and consequently important details may be erroneously treated.

Every cost installation should be given close supervision by the cost accountant until he feels that the client's staff can reasonably be expected properly to handle the work. However, regardless of this close supervision during the installation and the conscientious efforts of the client's staff both during the installation and afterwards, errors of principle often develop. Unless promptly detected and rectified these errors of principle may be repeated many times, depending upon the frequency with which the same detail may arise. It is thus apparent that quite serious misstatements may be embodied in the cost results.

As a means of eliminating this condition and assuring maximum results from the cost installation, the cost audit has been developed. It is the province of the cost audit to investigate every operating phase of the cost system. This work should not in any way interfere or dispense with the regular financial auditor. It should supply him with cost details upon which he can place more confidence in preparing his statements of operating results and inventories.

GENERAL SCOPE

The cost audit generally may be said to cover an examination of the details under the following headings:

- Purchasing
- Stores
- Material cost
- Labor cost
- Burden cost
- Waste and defective work
- Cost summaries
- Cost of production
- Cost of sales
- Monthly executive statements

Some of the more important details found in each of these divisions together with the auditing procedure will be considered in the following discussion:

Purchasing:

Care should be taken to insure that the purchasing department shall receive a written requisition for every article purchased, in such form that the order can be placed directly therefrom. Quotation records should be maintained and constantly kept up to date so that requirements may be filled in the quickest and best way.

An examination test of the purchase orders should be made. It is important that all vendor's invoices and goods-received slips be checked against the purchase order. This will serve to verify both prices and quantities.

The method used in following up purchases is an important consideration and the feasibility of graphic purchase control boards should be kept in mind.

Stores:

Detailed attention should be devoted to an examination of the methods used in requisitioning materials and to the obtaining of records of deliveries made. The stock-cards or books should be thoroughly examined. A stock record examination is essential whether the material purchase costs are carried on the stock records or not. Enough of the material requisitions and receiving slips and production reports should be checked to the stock records to satisfy the accountant that this important phase of the work is receiving proper attention.

To verify the material costs used, representative invoices should be checked against the stock-cards. No attempt should generally be made to verify all items, for, if representative prices are checked, those remaining can easily be verified merely by comparison. As a means of further checking the clerical accuracy of the records, a certain quantity of the cards should be added and the unit costs verified. The number of cards to check in this way will depend on their quantity as well as the variety of the materials handled. A slide rule will be found of assistance in this work.

After completing the clerical verifications, exhaustive tests should be made of the accuracy of the final results by comparing the balances shown on the stock-cards with the physical inventories

and the bin-tags. A record and analysis should be made of any variations so discovered and the variations should be reduced to a percentage basis. This will serve as a means of working towards correct book controls.

The proper balancing of purchases with consumption and quantities on hand is of the utmost importance. Few organizations devote sufficient thought to this important feature. It is not at all unusual to find factories carrying raw materials or partly-finished stock in excess of normal production requirements. As a result capital is unnecessarily tied up and valuable space is occupied solely because of the lack of proper planning.

A good cost system will bring these facts to light. However, it sometimes happens that this is one of the important duties which is neglected after the cost accountant has completed the installation and delegated the operation of the plan to the client's staff. Therefore, the cost audit programme may well place this phase of the investigation among the important steps to be taken.

The physical arrangement of the various store-rooms, the handling of work in process and the stores personnel are matters that should be given thought by the accountant.

Material Cost:

It will be necessary to verify the material costs used on the cost summaries. In some industries, materials are purchased for specific orders and the costs are charged directly thereto. Sometimes, the price of one lot of material is applied until the lot is exhausted, when the next oldest lot price will be used. Again, the material cost may represent a unit obtained by averaging the cost of all like materials purchased. The plan will depend on applicability to the particular industry.

Regardless of the method of obtaining the unit material costs, the results shown by the stock records should be checked to the cost summaries to verify the accuracy of the prices used in cost calculating.

Another important matter is accurate material specifications. Whether the conversion basis is weight, count, pound or square feet, correct cost results demand correct units on which to apply the cost price. A careful check of these units should be made. Errors are frequently discovered which are due to faulty weighing of units or incorrect computations.

As the material specifications are not generally as constantly checked as the labor costs, errors in their calculations may have a vital bearing on cost results since the mistake will be multiplied many or few times, depending on the number of varying calculations using this erroneous base.

Labor Cost:

The clock in and out cards should be compared with the work reports to an extent sufficient to satisfy the accountant that they are in substantial agreement. The work report cards should be checked against the payroll in sufficient quantities to provide a substantial check on the payroll. The same work reports should be traced to the cost collection records. In this way a direct check is obtained between the operating results and the detail costs. A check should be made on the wage rates, including hourly, piece and bonus rates and efficiencies, etc., by checking the original wage recommendation slips against the labor records, the payroll and the cost collection records. Of course the procedure will vary according to the wage-payment methods in use. Under the straight piece-work plan, this phase of the work will be quite simple, as the piece prices authorized can be traced directly to the cost records. Where straight day-work is in use, records will have to be maintained converting the rate per hour to a definite cost per unit unless the labor is to be charged directly against a specific job order. In either case the details should be verified. If the plant or department operates under the bonus, premium or other kindred wage system, consideration should be given to the original rates, the standard efficiencies, the actual efficiencies, etc., in order definitely to determine the influence each has exercised on costs.

Consideration should be given to a study of the classes of labor treated as indirect. Enough of the indirect reports should be checked to the payroll as well as to the cost collection details to satisfy as to their accuracy. After the labor details have been completely verified, the results should be checked to the cost summary established for each article or representative group of articles produced.

The total cost value of direct labor in work in process as shown by the detail records will then be compared with the labor-in-process control account for the month. The month used may well be the one next preceding the date of the examination. In this way an excellent check on the total labor will be obtained.

Burden Cost:

An investigation should be made of the expenses charged to the manufacturing as compared with those charged to the administrative and selling divisions. Errors are frequently made in distinguishing between these two classes of expense.

Next for consideration is the basis of factory burden distribution and the actual division of the expenses between departments or production centers. Thought should then be given to dividing the commercial expenses between the administrative and selling sections of the business. Finally comes a study of the methods used in applying all burden to costs.

Factory Expense:

A sufficient quantity of invoices should be checked to the expense records to satisfy as to the accuracy of the latter. All the elements entering into the distribution of the expenses by departments should receive careful scrutiny.

The various distribution bases should be studied. It is often found that much time is used in analyzing and distributing burden to departments upon a basis so incorrect as to make the results of no practical value for cost-accounting purposes. The accountant should devote careful attention to this problem. He will find whether the bases used are fundamentally sound and correctly represent existing facts or not. No phase of cost accounting can be more easily controlled than can the burden and yet no other phase of cost accounting is so frequently incorrectly treated.

With the principles satisfactorily examined, attention should be devoted to making a test of the clerical details of the distributions.

The factory expenses and their distribution to departments or production centers have now been verified. Next the basis of applying these expenses to costs should be considered. While there are several commonly-used methods of applying burden the percentage-on-labor plan will be considered here for purposes of illustration.

It is evident that unless the burden application is properly controlled, correct results will not be obtained regardless of the care used in the distributions. Consequently, the direct labor of each department having a separate burden-rate should be produced monthly. This direct labor should be traced to the payroll. The burden-rates obtained by dividing the burden by the direct

labor should be checked. These burden-rates will then be traced to the cost summaries or other point of burden application.

The value of assets on which depreciation is calculated and the rates used should be examined. These asset values should be in substantial agreement with the ledger accounts. Care should be taken to study the collection and distribution of the other fixed charges, such as taxes, insurance and power-plant expense. Serious thought should be given to the methods used in handling returns, repair-shop expense and expenses of a like nature that are sometimes accorded scant attention.

Commercial Expense:

A correct split between administrative and selling expense is of vital importance. Any one having experience in industrial concerns can doubtless recall many discussions between the sales and accounting departments regarding charges made to selling of supposedly questionable items from the sales manager's point of view. But of far more importance than the personal satisfaction of any of the individuals involved is the necessity of having these charges made correctly, because of the erroneous executive reports that will flow from mistakes of this character. It is, therefore, advisable to test this phase of the work by tracing a sufficient number of entries back to original invoices.

After analyzing the distributions, representative burden summaries should be tested. The basis used for obtaining the expense percentage—for instance, the cost of sales—should be checked to this burden summary. Next in order is the verification of the final burden-rates. These are then checked to the cost summaries or other burden application point of control.

Waste and Defective Work:

Too much emphasis cannot be placed upon the importance of obtaining accurate waste and defective-work records. In every factory this is a vital problem. To say that the annual loss from waste and defective work frequently places the operating results on the wrong side of the ledger would not be far wrong. Losses of this nature are somewhat intangible and more or less apt to be overlooked. An optimistic executive dismisses the thought with the statement that so small are these losses they are not worth considering.

Knowing the importance of the waste and defective-work records, the accountant will investigate each phase of the problem. He will carefully check the waste reports. He will consider the results shown in the light of his experience in like plants elsewhere. The trend of the waste curve will be noted as throwing light on the problem. Any marked tendencies either up or down should be explained by the management. Next the waste rates should be checked to the cost-collection records. The defective-work reports should be examined as a means of discovering the cause of defect and the ratio of defective work to good production. Tests of the costs used in pricing these reports should be made from the cost records. A sufficient test of the clerical computations should also be made. Finally the defective-work total values will be posted to the proper accounts in the works ledger.

Cost Summaries:

After completing the details all the cost elements contained on the cost summaries will have been verified. Representative quantities of these summaries should then be examined and added to detect clerical errors. A study of the supporting cost records is essential when they represent standard costs.

In many industries the use of standard costs is of a great deal of assistance in aiding production through intelligent cost accounting. Many times definite cost standards correctly applied unearth and reflect inefficiencies in operating that otherwise would remain hidden.

Unless the standard rates are constantly checked against the actual results, however, very misleading and erroneous conclusions may be formed. The great advantage of the standard cost plan is to have at all times definitely-known basic standards with which to gauge constantly fluctuating actual operating results. With this comparison of actual results against standard rates omitted or half-heartedly carried out the important feature of an excellent cost plan is lost. Gross inaccuracies in cost standards are not unknown and they reflect seriously on the value of the cost system as a whole.

The ultimate use made of the cost results is also a subject worthy of careful analysis. A good cost system should be a valuable aid to the management in efforts to increase production. Obtaining the cost is only one of its functions. Frequently, however, valuable manufacturing data are allowed to remain buried simply because the cost accounting details do not require the use

of such information. In their efforts to produce accurate cost results, many corporation accountants lose sight of the importance of statistical records. In many ways the average executive's conception of cost accounting has changed materially in the past few years and progressive industrial managers are increasingly realizing the value of correct, modern, cost-accounting methods.

Cost of Production:

The detail production records should be checked to the stock records to verify the proper inclusion in stores of all goods produced. They should also be checked to the production summaries. A sufficient quantity of the cost prices used will be checked from the cost summaries. A test should follow of the clerical computations, additions and extensions. The final total will then be posted to the books.

Cost of Sales:

There is need of accurate cost-of-sales figures. When it is remembered that the cost of sales directly affects the profit-and-loss statement and the finished goods inventory, the necessity of obtaining correct results is apparent. A considerable quantity of the units sold will be posted to the cost-of-sales collection sheets. The cost prices should be checked from the cost summaries. Certain of these units sold should also be checked to the finished stores records. The extensions and additions will then be tested and the results will be posted to the financial books.

Monthly Executive Statements:

One of the most important duties of the general auditor is a thorough examination of the monthly executive statements. The details and results obtained should be carefully analyzed. A trial balance of the works ledger and private ledger at the date of the examination should be obtained. All balances shown should be checked to the ledgers. This procedure will serve more thoroughly to verify the cost results. Each item shown on the executive statements will be checked to the ledgers. The extensions and footings should be verified.

While this detailed procedure is being carried out by assistants, the accountant will devote considerable study to the executive statements that have been presented previously. The obtaining of reports each month covering the business operations is frequently the factor that decides an executive's mind in favor of a

cost system. He wants and ought to expect to be able to have accurate reports presented to him promptly at the end of each month. Having confidence in them, he directs his business ship accordingly. If the reports are incorrect the wrong business course is taken with results serious or trivial, depending on the importance of the expedition. There is a tendency on the part of many bookkeepers entrusted with the preparation of reports to use the results shown by the books and records without a comprehensive analysis to determine whether these results appear relatively reasonable or not. The accountant should therefore be constantly watching for entries of this nature.

CONCLUSION

It is, of course, manifestly impossible to prescribe a cost-audit programme that will exactly fit all conditions. Each cost audit contains as many peculiarities as there are differing industries. But, in general, the foregoing procedure has been found of practical application as a working basis in varying industrial organizations.

The cost audit is intended as a direct step towards developing and maintaining sound methods of cost accounting. It serves as a means of protecting the executive against faulty periodical reports. It makes for more efficient results in the cost department, since each operative knows that his work will be audited.

When the investigation is complete, the accountant will present his report setting forth the results of the examination and embodying suggestions for improvement.

Trial-balance Information

By B. W. HODGES

When monthly profit-and-loss statements are impracticable owing to difficulty of securing trustworthy inventory and gross profit on sales cannot be gauged by past experience, the trial balance frequently contains all the information there is available.

One chief concern of the average executive just now is the financing of his business, and to know the changes in the position of his assets and liabilities is of prime importance. By comparing trial balances and summarizing the changes in accounts, the net result of the month's transactions can be viewed in the perspective and changes in position readily noted.

The executive can usually grasp this information much easier if it is placed in a receipts and disbursements form. The following exhibits will illustrate this point.

EXHIBIT A

COMPARATIVE TRIAL BALANCE

DEBITS	Feb.	Jan.	(+) Increase (-) Decrease
Cash	\$5,000	\$6,500	—\$1,500
Notes and accounts receivable.	35,000	30,000	+ 5,000
Fixed assets	55,000	54,000	+ 1,000
Purchases and inventory	60,000	50,000	+10,000
Selling expense	2,500	2,000	+ 500
Administrative expense	1,500	1,100	+ - 400
Insurance	800	700	+ 100
Interest	900	850	+ 50
	<u>160,700</u>	<u>145,150</u>	<u>+15,550</u>
CREDITS			
Notes and accounts payable ..	25,000	16,650	+ 8,350
Sales	55,000	47,500	+ 7,500
Capital stock	50,000	50,000	
Surplus	30,700	31,000	— 300
	<u>160,700</u>	<u>145,150</u>	<u>+15,550</u>

SUMMARY OF CHANGES IN ACCOUNTS

NET INCREASE IN VALUES RECEIVED

Increased notes and accounts payable	\$8,350	
Reduced bank balances	1,500	\$9,850

Trial-balance Information

DISPOSITION

Increased notes and accounts receivable	5,000	
Increased fixed assets	1,000	
Purchases increase	\$10,000	
Less sales increase	7,500	
Net merchandise increase	2,500	
Selling expense for month	500	
Administrative expense for month	400	
Insurance paid for month	100	
Interest for month	50	
Paid income tax (surplus reduced)	300	9,850

EXHIBIT B

COMPARATIVE TRIAL BALANCE

	Mar.	Feb.	(+) Increase (-) Decrease
DEBITS			
Cash	\$5,250	\$5,000	+ \$250
Notes and accounts receivable	29,000	35,000	- 6,000
Fixed assets	55,000	55,000	
Purchases and inventory	65,000	60,000	+ 5,000
Selling expense	2,950	2,500	+ 450
Administrative expense	1,875	1,500	+ 375
Insurance	825	800	+ 25
Interest	950	900	+ 50
	<u>160,850</u>	<u>160,700</u>	<u>+ 150</u>
CREDITS			
Notes and accounts payable..	19,150	25,000	- 5,850
Sales	61,000	55,000	+ 6,000
Capital stock	50,000	50,000	
Surplus	30,700	30,700	
	<u>160,850</u>	<u>160,700</u>	<u>+ 150</u>

SUMMARY OF CHANGES IN ACCOUNTS

NET INCREASE OF VALUES RECEIVED

Sales increase	\$6,000	
Less purchases increase	5,000	
Net receipts from merchandise	\$1,000	
Notes and accounts received reduced	6,000	\$7,000

DISPOSITION

Reduced notes and accounts payable	5,850	
Increased bank balances	250	
Selling expense for month	450	
Administrative expense for month	375	
Insurance paid	25	
Interest paid	50	7,000

It will be noted from exhibit A that the business is expanding; that the money received from increased current obligations is being tied up in fixed assets and expenses (a dangerous practice),

whereas the following month exhibit B shows liquidation and a healthier aspect. While the above figures give no indication of profits or losses, except such as might be judged from the volume of business, they do show the shifting of values, which is interesting and important information.

If the number of accounts carried is large, they can be classified and shown on supporting schedules, only the totals of each class appearing on the comparative trial balance and summary.

In making up the summary it should be remembered that the positive debit balances plus negative credit balances equal positive credit balances plus negative debit balances.

The JOURNAL of ACCOUNTANCY

Official Organ of the AMERICAN INSTITUTE OF ACCOUNTANTS

A. P. RICHARDSON, *Editor*

EDITORIAL

Admission Requirements of the American Institute

When the American Institute of Accountants was formed in 1916, one of its fundamental principles was the requirement that all persons admitted to the Institute after the original charter members had been admitted should come in only by way of the Institute's own examinations. The need for some regulation of the profession by the profession was manifest to all, and it would have been futile to attempt to build a strong organization based upon material so variable as that produced by an utterly unstandardized series of state examinations.

Everyone recognized that the Institute was an experiment, and there were some who had doubts as to the possibility of establishing a strong organization with admissions so restricted as would necessarily be the case in a society limiting its members to those who had passed high technical examinations. The experiment, however, was a success much greater than even its most hopeful sponsors had expected, and it is noteworthy that with the exception of a decreased ratio of additions during the period of the war, the numbers of members have increased more rapidly year by year.

One of the unexpected developments following the formation of the Institute was the adoption of the Institute's examinations by a number of the states, with the result that in a majority at least of the states there was a standard of examination and a fairly rigid adherence to a standard in the grading of candidates' papers. Following this development, the question occurred to the board of examiners of the Institute and to many other members of the Institute, whether or not it might be possible to extend a certain

amount of recognition to certificates issued in states in which the requirements were generally satisfactory even if such states did not feel themselves in a position to enter into the plan of coöperation with the Institute. This question with others was discussed at a series of meetings of members of the Institute held throughout the country during the past winter. The matter was brought before the council of the Institute at the meeting of April 10, 1922, and, after deliberation, the thought was expressed that it might be well for the board of examiners to consider the possible desirability of giving recognition in certain cases to the results of examinations conducted outside the plan of coöperation.

The board of examiners, pursuant to the council's suggestion, considered the matter and adopted a new rule which we believe will be of interest to nearly all the readers of this magazine. The following paragraphs are quoted verbatim from the amended rules of the board:

OTHER EXAMINATIONS

Until further notice, the board of examiners in its discretion exercised in the case of any individual applicant for admission to the Institute may accept in lieu of its own examinations a certificate as a certified public accountant of any state of the United States, the laws of which are held by the board of examiners of the Institute to be adequate and well administered, or a certificate of membership in a society of professional accountants in a foreign country whose requirements for admission are considered by the board of examiners of the Institute equivalent to the Institute's examinations, provided that such applicant shall have received such certificate as certified public accountant or member of a society of professional accountants after adequate examination and that he shall have been in practice as a public accountant or in the employ on the accounting staff of a public accountant for a period of two years next preceding the date of his application, and provided further that he shall be recommended for admission by three members of the Institute residing near the place of residence of the applicant, such members to be selected by the board of examiners without knowledge of the applicant and to report to the board of examiners upon the applicant's professional qualifications, character and reputation.

In the case of an applicant conforming to all the provisions contained in the foregoing paragraph and presenting evidence of five years' public practice immediately preceding the date of his application or ten years' public practice, one year of which shall have immediately preceded date of application, the board of examiners may require such applicant to submit a thesis upon one of a group of subjects to be designated by the board and upon the result of such thesis may recommend the applicant for admission as member of the American Institute of Accountants. The board, however, may accept other evidence of professional qualifications in lieu of a thesis.

There are several features in the foregoing rule which are worthy of special notice.

In the first place, the rule is applicable "until further notice." Consequently, it may be inferred that the board does not intend that such recognition shall be continued indefinitely.

The requirement of an examination of an applicant's qualifications by members of the Institute investigating and reporting without the knowledge of the applicant bears a striking similarity to the restrictions placed upon admission to various fraternal organizations. It should not operate to preclude the admission of any desirable applicant, but it may be expected to render extremely unlikely the admission of unworthy persons.

It is well, in reviewing these amended rules of the board of examiners, to draw attention again to the provision for oral examinations which has existed since the board of examiners began its functions. Oral examination is intended to provide a means of entrance for accountants who are more familiar with the actual work of the profession than with the theory which is so largely and necessarily a part of written examinations. Let us quote from the syllabus prepared by the board the following description of the oral examinations and requirements.

EXAMINATIONS—ORAL

Under the provisions of the constitution the board of examiners is permitted to require candidates to pass written or oral or partly written and partly oral examinations.

The rules of the board of examiners provide that persons who are over 30 years of age or are certified public accountants or possessors of equivalent foreign degrees approved by the board of examiners may be subjected to oral instead of written examination, provided such applicants present evidence of having been in public practice for seven years or in practice on their own account for five years.

Oral examinations are technical in character and are designed to demonstrate the applicant's practical knowledge of accounting. The questions are based upon the questions of the written examinations, but an effort is made to permit practitioners who have been in practice for many years to explain their treatment of principles and cases involved in a somewhat more informal way than would be possible in a written examination.

Each candidate is examined separately, and the transcript of all questions and answers is presented to the entire board for consideration.

Oral examinations under the rules of the board of examiners must be conducted by members of the board of examiners. Such examinations are usually held in the principal centers of accounting activity, such as Boston, New York, Chicago and San Francisco, but special sessions may be held elsewhere in the discretion of the board of examiners.

By means of the provisions which have been quoted, it should be possible for every eligible and desirable accountant of either sex to obtain admission to the national body of professional accountants. Naturally there must be clear evidence that the applicant is a fit and proper person to present himself or herself to the public as a practitioner, and in order to demonstrate that fitness

there must be examination. It cannot be said, however, that the restrictions are narrow, nor can it be shown that they are unnecessarily severe. They demonstrate the Institute's desire to admit to its membership all who are justly entitled to the honor; and we believe that when these facts are duly considered there will be a considerable number of applicants who will seek admission under the comprehensive interpretation which the board gives to the provisions of the constitution of the Institute.

The board makes it known that it will welcome applications from all who are eligible, and it urges upon the profession as a whole the consideration of the benefits to be derived by every practitioner from united effort in the cause of better accountancy which the Institute has served so effectively in recent years.

The board of examiners has prepared for distribution a new edition of its circular of information and syllabus containing all the amendments and additions now in force. Copies of this circular may be obtained from the office of the Institute in New York.

Audit Working Papers

The endowment fund of the American Institute of Accountants is about to announce for publication in the fall a practical text-book on audit working papers which is now being prepared by J. Hugh Jackson. Mr. Jackson was formerly assistant professor of accounting at Harvard and is now associated with Price, Waterhouse & Co. This firm has agreed to donate to the endowment fund the copyright of the forthcoming book without cost for the preparation of the material. The net proceeds of sales will accrue wholly to the endowment fund.

The book is to be illustrated with photographed schedules in considerable numbers, and will contain an explanatory text which should make it of the utmost service both for practical purposes and as a college text-book.

Further details of the publication will doubtless appear in subsequent issues of this magazine.

Income-tax Department

EDITED BY STEPHEN G. RUSK

Our attention has been directed to a report made to the New York County Lawyers' Association by its committee on the unlawful practice of law, wherein are set forth examples of the evils arising from the performance of legal work by those unqualified and incompetent in matters of law. The investigation of this committee disclosed among other things that in advising upon and in the preparation of income-tax returns the line between the work devolving upon the lawyer and that upon the accountant is difficult to draw. The committee is of the opinion that the accountant is not competent to advise a taxpayer upon such matters as "the domicile of citizens, the effect of increasing or decreasing corporate stock, the advantage of trading in corporate or in individual and partnership form." It regards such questions as intricate and complicated questions of law. Its conclusions are quoted as follows:

"Patently advice along these matters requires the services of a skilled and experienced lawyer; nevertheless the preparation of income-tax returns and accounting work in themselves are primarily the work of a skilled accountant."

A further conclusion of this committee is that:

"There can be no question that where a lawyer divides fees with a firm of accountants for procuring of legal business arising originally out of employment solicited for the accountant in connection with income-tax matters, or where the layman performs purely legal services for which he is not qualified, a violation of law exists."

We imagine that no fault will be found by accountants with the general proposition that their profession does not qualify them to give advice upon legal matters. There are accountants, we must admit, who have not hesitated to advise their clients upon questions that it would have been better to leave to the lawyer, but these instances are rare. However, instances where lawyers have sought to make income-tax returns when intricate and complex accountancy was involved (and this to the detriment of the interests of the clients) are numerous. The proportion of lawyers qualified to advise upon income-tax matters and to prepare income-tax returns apparently is not large and numerous instances could be cited wherein great harm has been done by lawyers in attempting to solve problems for which they were not qualified.

With the conclusion of this committee as to dividing fees we can find no fault, but we do not wholly agree that the accountant's work should be confined in the small limits set for it by the committee. "The preparation of income-tax returns" necessitates familiarity with the income-tax law, the regulations promulgated for its interpretation and the large body of decisions (court, solicitor's and office) that are continually being made. Surely the accountant does not violate the law when he counsels with his client concerning matters with which he must be familiar.

The committee reports that the federal government has sanctioned the practice permitting laymen, whom it describes as "clerks in department stores and banks and others," to assist in the "filling out and preparation of income-tax blanks." It did not report that the federal government also sanctions the appearance before its tribunal of "agents" for the taxpayer, with the view to facilitating the proper application of the law.

It is fortunate for the taxpayer that the federal government has found no difficulty in making distinctions and we feel that some one should inform the lawyers' committee of the large and important part members of the American Institute of Accountants took in the preparation of the several revenue acts and of the regulations and of the assistance they have given in preparing opinions that have been contained in the treasury and other decisions based on these acts. We believe the committee should also send for the regulations of the treasury department wherein are set forth rules that are to govern those who are admitted to practise as attorneys or agents before the department. It will then see among other things that the advertising attorney or accountant is barred from appearing in his capacity as attorney or agent before the department, which should prove that the treasury department is jealously distinguishing between those genuinely qualified and those who are not.

* * * *

Among the decisions handed down recently one that is of outstanding interest is No. 3333 which sets forth "ratios of postwar costs of replacement for use in preparation of claims for amortization." The department points out in the decision that the purpose of these ratios is to facilitate the preparation and examination of claims and to bring about uniformity as to basis for claims." The allowances based on these ratios it must be understood are purely tentative and are subject to redetermination in accordance with the provisions of the law.

TREASURY RULINGS

(T. D. 3329—May 13, 1922)

Income tax—Priority of consideration.

Expeditious disposition of tax cases in which an emergency has been found to exist.

If, upon application of any taxpayer, it be shown to the satisfaction of the commissioner (1) that the taxpayer is in the hands of a receiver and a reorganization is necessary; (2) that the taxpayer is in financial difficulties, either actual or imminent, and refinancing is necessary; or, (3) that the distribution of a fund in which a large number of people may be interested is held up pending the determination of the amount of income or profit taxes which must be paid out of the fund—then the commissioner will declare an emergency to exist with reference to such case and will direct that the matter be given priority of consideration with a view to the expeditious determination of the particular tax liability.

Application for such priority of consideration shall be in the form of a letter addressed to the commissioner and shall be supported by statements under oath setting forth in detail the facts upon which the

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request for special consideration is based, and the particular reason why such person believes himself entitled to have the case expedited as provided herein.

(T. D. 3330—May 13, 1922)

Income tax—Revenue act of 1918—Decision of court.

1. INCOME TAX—DEDUCTION—WISCONSIN SOLDIERS' BONUS TAX.

The plaintiff was a corporation, keeping its accounts and filing returns upon an accrual basis, and annually set up upon its books a "reserve" for income taxes due the state of Wisconsin, under the laws of which it was organized. Under the provisions of section 234 (a) (3), revenue act of 1918, the company deducted from its federal income-tax return for the year 1918 the "reserve" for income taxes due the state at the rate in effect on December 31, 1918. On July 30, 1919, the Wisconsin legislature passed a "soldiers' bonus" act, which provided for the raising of the money by a single tax levy of one mill on all assessed property for the year 1919, and a surtax over the normal tax on the incomes of corporations upon the basis of the 1918 state income-tax returns. After the ratification of the soldiers' bonus act on October 10, 1919, the plaintiff filed an amended federal income-tax return for the year 1918 and sought to deduct therein as taxes accrued for the year 1918 the amount of additional taxes due the state under the soldiers' bonus act. *Held*, that the basis of the levy of the soldiers' bonus tax was 1918 incomes, but there is no relation between the basis for the state levy and the time of the accrual of the tax for federal tax purposes.

2. DEDUCTION—STATE TAXES—"ACCRUED" WITHIN THE YEAR—SECTION 234 (a) (3), REVENUE ACT 1918.

A tax does not "accrue" until it becomes a liability of the taxpayer, and a tax can not be "accrued" and deducted for federal income-tax purposes in the year 1918 where the state act creating the tax liability was not passed until the year 1919.

The appended decision of the United States Circuit Court of Appeals for the seventh circuit, affirming the judgment of the United States District Court for the western district of Wisconsin in the case of *Ed. Schuster & Co. (Inc.)*, v. *Williams*, collector, is published for the information of internal-revenue officers and others concerned.

UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT.
No. 3039. OCTOBER TERM, 1921. JANUARY SESSION, 1922.

Ed. Schuster & Co. (Inc.), plaintiff in error, v. *Burt Williams*, as collector of the United States internal revenue for the district of Wisconsin, defendant in error.

ERROR to the district court of the United States for the western district of Wisconsin.

Before BAKER, ALSCHULER, and EVANS, circuit judges.

Opinion by ALSCHULER, judge:

Plaintiff in error, a Wisconsin corporation, with principal office at Milwaukee, duly made its return for the federal income tax for the year ending December 31, 1918. The return was on the "accrual" basis, and one of the deductions was of the income tax of the state of Wisconsin, at the rate in effect December 31, 1918.

July 30, 1919, the Wisconsin legislature passed a "soldiers' bonus" act, which provided for the raising of the entire bonus by one tax levy of 1 mill on all assessed property for the year 1919 and a surtax over the normal tax upon the incomes of corporations, upon the basis of Wisconsin income-tax return for the calendar year 1918. (Wis. Laws, 1919, ch. 667.) The act by its terms did not become effective until ratification by a popular vote, which occurred October 10, 1919. The soldiers' bonus tax which this corporation was required to pay on the basis of the 1918 return for state income tax was not, and in the

nature of things could not have been, included in its deduction of "reserve for taxes" in its federal income-tax return for 1918, which it made in June, 1919. But upon the favorable vote on the act the corporation filed an amended income-tax return for the year 1918, wherein its soldiers' bonus tax, payable on the basis of the Wisconsin income-tax return, was additionally included in the deduction of "reserve for taxes" in its 1918 federal income-tax return, by which further deduction its federal income tax due the United States for the year 1918 would be reduced by nearly \$10,000 below the tax as originally returned. Corresponding abatement from the tax as first returned was duly demanded, and the claim therefor duly rejected on the ground that the soldiers' bonus tax did not accrue in 1918 and could not be included in reserve for taxes for that year, but that the deduction must be made from profits and income for the year 1919. The higher federal income-tax rate for 1918, and perhaps larger income for that year, made it advantageous to the taxpayer to take the deduction from the 1918 profits rather than from those of 1919.

The federal income-tax law provides:

Sec. 234. (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions: * * *

(3) Taxes paid or accrued within the taxable year imposed (a) by the authority of the United States, except income, war-profits and excess-profits taxes; or (b) by the authority of any of its possessions, except the amount of income, war-profits and excess-profits taxes allowed as a credit under section 238; or (c) by the authority of any state or territory, or any county, school district, municipality or other taxing subdivision of any state or territory, not including those assessed against local benefits of a kind tending to increase the value of the property assessed.

The only question is whether the Wisconsin soldiers' bonus tax of 1919 accrued in 1918 so as to be deductible from the gross corporate income for 1918.

The bonus act provided that the bonus fund be raised by a single levy of a 1-mill tax on all property, and a stated surtax on all corporate incomes as returned to the state for the year 1918. It is not contended that the 1-mill property tax accrued in 1918. But would this have been any more a tax accrued in 1918 had the act provided that the basis of its levy should be the property assessment for 1918? We think not. It was none the less a tax accruing in 1919, whether the basis of levy was the assessment of 1918 or of some earlier year.

There is no necessary relation between the basis for the levy and the time of the accrual of the tax. Whether computed on a property assessment or a state income-tax return, the tax did not accrue until it became a liability of the taxpayer. Since the act creating the tax was not passed until after the federal income-tax year of 1918, this soldiers' bonus tax can in no sense be deemed to have accrued during the calendar year prior to that of its passage.—*United States v. Woodward et al.* (June 6, 1921, 256 U. S. 632.)

This tax, not accruing in 1918, is not a proper item of deduction for that year, and the district court correctly sustained the demurrer to the declaration filed in this suit to recover the paid tax from the collector of internal revenue.

The judgment is affirmed.

(T. D. 3333—May 19, 1922)

Ratios of estimated postwar costs of replacement for use in preparation of claims for amortization.

Pursuant to article 184 of regulations No. 62, the commissioner has determined and publishes the following ratios of estimated post-

Income-tax Department

war cost of replacement for use by taxpayers in computing claims for tentative allowance for amortization.

The purpose of establishing these ratios is to facilitate the preparation and examination of claims and to bring about, to such extent as may be practicable, uniformity as to the basis of claims. The allowances based thereon will be purely tentative and subject to redetermination in accordance with the provisions of the law.

These ratios, condensed as they are to cover 16 groups, are necessarily composite figures, arrived at by an examination of many items entering into the respective groups, and it is realized that in some cases where only a limited number of items in the group are involved, the ratios given may not fairly be applicable to a particular case. In such cases the claim for amortization should be made in accordance with the ratios published, but the taxpayer, along with his claim, should submit a statement showing in detail the reasons why, and the extent to which, such ratio is not properly applicable to his claim, so that such cases may receive special consideration; in like manner, there may be cases where the ratios as applied to the particular claim would give the taxpayer more than a reasonable allowance, and in such cases the ratio properly applicable will be determined on the examination of the claim and the taxpayer given notice thereof.

All ratios are expressed in percentages based on prices as of June 30, 1916.

- A. Ratios for computing estimated postwar cost of replacement of buildings, vessels, cars, tanks, blast furnaces, open-hearth furnaces, annealing furnaces, electric furnaces, coke ovens and construction of all kinds:
- | | Per cent. |
|--|-----------|
| 1. Lumber— | |
| (a) Hard | 240 |
| (b) Soft | 175 |
| 2. Structural steel | 60 |
| 3. Building materials, other than lumber and structural steel | 225 |
| 4. Steel (other than structural steel) and steel products | 90 |
| 5. Building equipment | 150 |
| 6. Labor (all classes) | 160 |
- B. Ratios for computing estimated postwar costs of replacement of machinery and equipment:
- | | Per cent. |
|---|-----------|
| 7. Electrical machinery and equipment | 130 |
| 8. Engines, turbines, compressors and similar facilities | 175 |
| 9. Pumps | 135 |
| 10. Boilers | 160 |
| 11. Transmission equipment— | |
| (a) Shafting, pulley, hangers, etc. | 135 |
| (b) Belting | 100 |
| 12. Machine tools and small tools (machine tools are considered as that class of metal working machinery which can be used on both cast iron and steel) | 130 |
| 13. Wood-working machinery | 155 |
| 14. Textile machinery | 155 |
| 15. All other machinery (including cranes)— | |
| (a) Machinery, the cost of which did not exceed 10 cents per pound as of June 30, 1916 | 120 |
| (b) Machinery, the cost of which did exceed 10 cents per pound as of June 30, 1916 | 130 |
| 16. Office furniture and equipment | 125 |

Students' Department

EDITED BY H. A. FINNEY

INSTITUTE EXAMINATIONS

[NOTE—The fact that these solutions appear in THE JOURNAL OF ACCOUNTANCY should not lead the reader to assume that they are the official solutions of the American Institute of Accountants. They merely represent the personal opinion of the editor of the *Students' Department*.]

AMERICAN INSTITUTE OF ACCOUNTANTS

EXAMINATION IN ACCOUNTING THEORY AND PRACTICE—PART I

May 18, 1922, 1 P.M. to 6 P.M.

The candidate must answer the first four questions and one other question.

No. 1 (30 points):

A, B, C and D have been in partnership for three years, but, a misunderstanding having arisen, negotiations are in progress with intent to induce D to withdraw. The articles of partnership provide that the partners shall not be allowed any salaries but shall be permitted to make cash drawings of \$175.00 monthly. These amounts were drawn the first year. Then, by mutual consent, the drawings were increased the second year to \$200.00 each and the third year to \$225.00 each.

You are called upon to determine the amount to which D will be entitled if he decides to withdraw; and, in your examination of the books, you find the following facts which have not previously been brought to the attention of the partners.

The bookkeeper has charged the drawings to profit-and-loss, has not provided reserves for depreciation or bad debts; and it is now agreed that proper adjustment shall be made of these particular items.

An analysis discloses the following facts with regard to bad debt losses:

	First year	Second year	Third year	Total
Losses charged off as ascertained	\$139.50	\$378.60	\$489.75	\$1,007.85
Reserve which should be set up at the present time				615.85
Losses which arose from sales in various years	523.60	436.95	663.15	1,623.70

Annual depreciation is agreed upon at the rate of 5% of the cost of the buildings and at the rate of 10% of the cost of the furniture and fixtures, which have appeared on the books with the following balances:

	Buildings	Furniture and fixtures
Beginning of first year	\$5,400.00	\$ 950.00
Beginning of second year	5,950.00	1,075.00
Beginning of third year	6,200.00	1,215.00

The profits as ascertained have been credited to the partners' capital accounts in the agreed profit-and-loss ratios, and no other entries have been made in these accounts.

The following is an abstract of the capitals:

	A	B	C	D
Capitals, beginning of first year ..\$	5,000.00	\$ 8,000.00	\$12,000.00	\$15,000.00
Profits, first year	486.00	972.00	1,458.00	1,944.00
Capitals, beginning of second year ..\$	5,486.00	\$ 8,972.00	\$13,458.00	\$16,944.00
Profits, second year	685.20	1,142.00	1,827.20	2,055.60
Capitals, beginning of third year ..\$	6,171.20	\$10,114.00	\$15,285.20	\$18,999.60
Profits, third year	822.25	1,391.50	2,087.25	2,024.00
Capitals, end of third year	\$ 6,993.45	\$11,505.50	\$17,372.45	\$21,023.60

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The partnership articles provide that in the event of the withdrawal of any partner by mutual consent at the end of any year, the goodwill of the partnership shall be valued at $1\frac{1}{2}$ years' purchase of the profits of the last year in excess of 6% of the total capital at the beginning of that year.

Show what amount D will be entitled to receive if he withdraws.

Solution: The first step is to adjust the profits and determine the true amounts which should be credited to D. This necessitates ascertaining what per cent. of the profits has been credited to D each year.

	D's share of profits	Total profits	D's per cent.
First year	\$1,944.00	÷ \$4,860.00	= 40%
Second year	2,055.60	÷ 5,710.00	= 36%
Third year	2,024.00	÷ 6,325.00	= 32%

The adjustment of the profits involves:

(a) Adding back the drawings, which should not have been treated as an expense, since the articles specifically state that salaries are not to be allowed.

(b) Adding back bad debt losses charged off and deducting true bad debt losses by years. This is essential because the profit-and-loss ratio has varied from year to year, and because the goodwill is to be based on the third year's profits.

(c) Providing depreciation on the buildings and the furniture and fixtures.

STATEMENT TO DETERMINE TRUE PROFITS AND D'S SHARE THEREOF *Exhibit A*

	First yr.	Second yr.	Third yr.
Profits, as stated in problem	\$ 4,860.00	\$ 5,710.00	\$ 6,325.00
Add back drawings, improperly charged to profit and loss:			
First year: $\$175.00 \times 12 \times 4$	8,400.00	.....	.....
Second year: $200.00 \times 12 \times 4$ .....	.....	9,600.00	.....
Third year: $225.00 \times 12 \times 4$ .....	.....	.....	10,800.00
Add back bad debts charged off	139.50	378.60	489.75
Total	<u>\$13,399.50</u>	<u>\$15,688.60</u>	<u>\$17,614.75</u>
Deduct:			
True bad debt losses by years	\$ 523.60	\$ 436.95	\$ 663.15
Depreciation of buildings:			
First year: 5% of \$5,400.00	270.00	.....	.....
Second year: 5% of 5,950.00 .....	.....	297.50	.....
Third year: 5% of 6,200.00 .....	.....	.....	310.00
Depreciation of furniture and fixtures:			
First year: 10% of \$ 950.00	95.00	.....	.....
Second year: 10% of 1,075.00 .....	.....	107.50	.....
Third year: 10% of 1,215.00 .....	.....	.....	121.50
Total deductions	<u>\$ 888.60</u>	<u>\$ 841.95</u>	<u>\$ 1,094.65</u>
True profits	<u><u>\$12,510.90</u></u>	<u><u>\$14,846.65</u></u>	<u><u>\$16,520.10</u></u>

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D's SHARE OF PROFITS

First year: 40% of \$12,510.90.....	\$ 5,004.36
Second year: 36% of 14,846.65.....	5,344.79
Third year: 32% of 16,520.10.....	5,286.43
Total	<u>\$15,635.58</u>

COMPUTATION OF GOODWILL

Exhibit B

Profits of the third year (exhibit A) ..	.....	\$16,520.10
Less 6% interest on capital at beginning of third year:		
Capital invested—beginning of first year:		
A	\$ 5,000.00	.....
B	8,000.00	.....
C	12,000.00	.....
D	15,000.00	\$40,000.00
Add profits of first two years (exhibit A):		
First year	\$12,510.90	
Second year	14,846.65	27,357.55
Total		67,357.55
Deduct drawings of first two years:		
First year	\$ 8,400.00	.....
Second year	9,600.00	18,000.00
Capital, beginning of third year ....	.....	\$49,357.55
6% interest thereon .....	.....	2,961.45
Profits of third year in excess of 6% interest on capital at the beginning of the third year		13,558.65
Multiply by		1½
Goodwill		<u>\$20,337.98</u>
D's share: 32% thereof		<u>\$ 6,508.15</u>

Goodwill should be divided among partners in the profit-and-loss ratio of the year when the division is made.

STATEMENT OF AMOUNT DUE TO D (In event of withdrawal)

Exhibit C

Original investment	\$15,000.00
Add profits for three years (exhibit A)	15,635.58
Add goodwill (exhibit B)	6,508.15
Total	<u>\$37,143.73</u>
Deduct drawings:	
First year	\$ 2,100.00
Second year	2,400.00
Third year	2,700.00
Balance due D if he withdraws	<u>\$29,943.73</u>

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No. 2 (27 points):

You are called upon to prepare an adjusted statement of the surplus of the Washburn Manufacturing Company at December 31, 1918, and of the profits for 1919, 1920 and 1921.

The surplus account on the company's books appears as follows:

SURPLUS			
Dividends, 1919	\$ 40,000.00	Balance, Dec. 31, 1918..	\$235,000.00
" 1920	35,000.00	Profits, 1919	65,000.00
" 1921	20,000.00	" 1920	78,300.00
Balance, Dec. 31, 1921..	331,300.00	" 1921	48,000.00
	\$426,300.00		\$426,300.00

The company has not provided for accruals and deferred items in closing its books and has ignored the following items at the various dates of closing:

	Deferred charges	Deferred income	Accrued expenses	Accrued income
December 31, 1918	\$2,125.00	.....	\$5,200.00	\$ 475.00
" 31, 1919	2,640.00	.....	3,135.00	.....
" 31, 1920	3,100.00	\$1,250.00	6,120.00	290.00
" 31, 1921	1,950.00	700.00	4,200.00	.....

In closing the books the inventories were priced at cost or market, whichever was lower, and, in addition, reserves for possible future declines in market value were set up as follows:

At December 31, 1919	\$ 8,000.00
" " 31, 1920	12,600.00
" " 31, 1921	9,250.00

Each reserve was set up by a charge to profit-and-loss and remained on the books until the next closing, when it was credited to the account with the opening inventory. The reserve set up at the end of 1921 is still on the books.

Consigned goods have been included in the inventories at billed price. The company has billed all goods sent to consignees at 130% of cost. The following consigned goods inventories have been included:

At December 31, 1919	\$15,600.00
" " 31, 1920	10,400.00
" " 31, 1921	18,200.00

Prepare a corrected statement of the surplus account from December 31, 1918, to December 31, 1921.

Solution: The following statement of adjustments is self-explanatory, with the possible exception of the treatment of the reserve for inventory fluctuations. By valuing the inventories at the lower of cost or market at the end of each year, the company took up each year the loss on market declines accruing during the year. By charging profit-and-loss with an additional provision for future possible losses, the company anticipated the losses. This is a conservative thing to do, but the provision should be made from surplus, because the loss is not certain to occur, the amount is an estimate, and if it does occur it should be charged to profit-and-loss in the period when it does occur. The reserve should be provided from surplus, and the reserve set up at the end of one year should be returned to surplus during or at the close of the next year. So far as the profit-and-loss account is concerned, the inventories are valued at cost or market, whichever is lower, at the date of the closing.

THE WASHBURN MANUFACTURING COMPANY
STATEMENT OF SURPLUS AND PROFIT-AND-LOSS ADJUSTMENTS
December 31, 1918, to December 31, 1921

	Surplus Dec. 31, 1918	Profit-and-loss 1919	Profit-and-loss 1920	Profit-and-loss 1921
Balances—per books	Dec. 31, 1918	\$65,000	\$78,300	\$48,000
Deferred charges:				
Dec. 31, 1918	2,125	\$2,125		
" 31, 1919		2,640	\$2,640	
" 31, 1920			3,100	\$3,100
" 31, 1921				1,950
Deferred income:				
Dec. 31, 1920			1,250	
" 31, 1921				700
Accrued expenses:				
Dec. 31, 1918	\$5,200			
" 31, 1919		3,135		
" 31, 1920			3,135	
" 31, 1921			6,120	6,120
Accrued income:				
Dec. 31, 1918	475	475		
" 31, 1920			290	
Reserve for inventory fluctuation:				
Dec. 31, 1919		8,000	8,000	
" 31, 1920			12,600	
" 31, 1921				9,250
Profit on consigned goods inventories:				
Dec. 31, 1919: Billed	\$15,600			
Cost	12,000	3,600	3,600	
" 31, 1920: Billed	10,400			
Cost	8,000		2,400	2,400
" 31, 1921: Billed	18,200			
Cost	14,000			4,200
Adjusted balances	232,400	71,505	80,615	43,880
	<u>\$237,600</u>	<u>\$80,840</u>	<u>\$101,025</u>	<u>\$68,970</u>

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THE WASHBURN MANUFACTURING COMPANY ADJUSTED STATEMENT OF SURPLUS ACCOUNT December 31, 1918, to December 31, 1921

Surplus, December 31, 1918		\$232,400.00
Add profits: 1919		71,505.00
Total		363,905.00
Deduct: dividends	\$ 40,000.00	
Provision for possible inventory losses	8,000.00	48,000.00
Surplus, December 31, 1919		255,905.00
Add profits: 1920		80,615.00
Provision for possible inventory losses—Dec. 31, 1919		8,000.00
Total		344,520.00
Deduct: dividends	35,000.00	
Provision for possible inventory losses	12,600.00	47,600.00
Surplus, December 31, 1920		296,920.00
Add profits: 1921		43,880.00
Provision for possible inventory losses—Dec. 31, 1920		12,600.00
Total		353,400.00
Deduct: dividends	20,000.00	
Provision for possible inventory losses	9,250.00	29,250.00
Surplus, December 31, 1921		324,150.00
<i>Reconciliation</i>		
Balance of surplus—per books—Dec. 31, 1921 ...		\$331,300.00
Add: deferred charges, December 31, 1921		1,950.00
Total		333,250.00
Deduct: deferred income—December 31, 1921	700.00	
Accrued expenses—December 31, 1921	4,200.00	
Unrealized profit on consigned goods	4,200.00	9,100.00
Balance of surplus—per adjusted statement		\$324,150.00

No. 3 (10 points):

A corporation issued \$100,000.00 of 6% preferred stock on January 1, 1921, with a sinking-fund provision requiring that there shall be redeemed each year out of profits an amount of stock equal to 20% of the profits of the preceding year. The company is not to pay more than 105 for the stock, and any money in the fund which cannot be used to acquire stock at 105 or less is to remain in the fund until purchases can be made.

During 1921 the company made a profit of \$29,000.00, and in January, 1922, it created the fund in accordance with the provisions of the stock

issue. During February it purchased and retired 56 shares of preferred stock at 103.

Give entries for the establishment of the fund and the purchase and retirement of the stock.

Explain the difference between the operation of a sinking fund for bonds, and a sinking fund for stock.

State whether you think it is obligatory for the corporation to set up a sinking-fund reserve in conjunction with a preferred-stock sinking fund. If you think that the reserve is not obligatory, state whether or not it is advisable, giving your reasons.

If a reserve is created, state what entry is made to establish the reserve and what disposition may eventually be made of it.

Solution:

Preferred-stock sinking fund	\$5,800.00	
Cash		\$5,800.00
To set aside cash equal to 20% of the profits of 1921, to be used for the retirement of preferred stock.		
Capital stock preferred	5,600.00	
Surplus	168.00	
Preferred-stock sinking fund		5,768.00
To record the purchase of 56 shares of preferred stock at 103, and the cancellation thereof.		

The so-called preferred-stock sinking fund is not a true sinking fund. There are three elements to the definition of a sinking fund. A true sinking fund in the accounting and mathematical sense is a fund of assets (a) accumulating at compound interest (b) for the payment of a positive liability (c) at its maturity. A sinking fund for the retirement of bonds at maturity meets all these requirements. The fund accumulates at compound interest, the bonds are a positive liability, and the bonds are canceled at maturity. Even if the company buys for the sinking fund the very bonds for which the fund was established, these bonds may be held alive in the fund until their maturity. In fact, if the bonds are canceled when purchased the fund should be called a retirement fund and not a sinking fund.

In the case of a fund for stock, none of the requirements of the definition is met. The fund is used for the immediate purchase and cancellation of the stock; hence it does not accumulate at compound interest. The stock is not a positive liability, and it has no definite maturity. It would be more exact to call the fund a preferred-stock redemption fund.

The chief practical difference between a bond sinking fund and a stock sinking fund is that the former continually increases until the maturity of the bonds, but the latter is temporarily increased by the cash deposits and forthwith reduced by the purchase and retirement of the stock.

A sinking-fund reserve is not obligatory unless the provisions of the stock issue specifically require it. If there is such a provision, the contract with the stockholders necessitates the reserve. Even though the reserve is not obligatory, it is advisable to create one in order to appropriate profits and reduce dividends. If, in addition to making the sinking-fund contribution, the company pays dividends equal to the amount of its profits each year, it will deplete its working capital, thus jeopardizing future profits. It is better to hold a portion of the profits in surplus, and this is accom-

plished by setting up the reserve, which is merely an allocation of surplus. By doing so, the company provides for its immediate needs by an issue of stock, and as the stock is paid off the capital is replaced by profits left in the business.

If a reserve is created, the proper entry is a debit to surplus and a credit to the reserve. The reserve may be returned to surplus after the stock is all retired; or if the reserve was set up at the discretion of the board of directors and not in accordance with an agreement with the stockholders it may be returned to surplus at any time. After having been returned to surplus it may remain there indefinitely, or a stock dividend may be issued against it. In fact, a cash dividend may be charged to this surplus, but it would probably be a poor financial policy to do so, for it would merely result in dissipating the assets which the company had acquired through the programme of issuing preferred stock and replacing the capital thus acquired by the retention of profits.

No. 4 (10 points):

In consolidating the statements of a foreign branch with the statements of the home office, it is necessary to make conversions from foreign to domestic currency. At what rates should the balances of the following accounts be converted? Give your reasons.

Fixed assets.

Inventories at the beginning of the period.

Current assets.

Current liabilities.

Nominal accounts.

Answer: Fixed assets should be converted at the rate which was current at the date when the fixed assets were acquired. If the acquisitions were spread over a long period of time, there would be several rates. In order to avoid the inconvenience which results from this situation, the home office frequently carries the fixed assets on its own books, taking them up at the date of acquisition and at the rate current at that date. The rate at the date of acquisition should be used because of the fundamental principle that operating profits should not be affected by fluctuations in the market value of fixed assets. If any rate other than the rate at acquisition were used, the resulting dollar valuation would be different from the actual dollar cost, and thus an element of fluctuation of market values would be introduced.

Current assets should be converted at the rate at the date of the statement, because the theory is that these current assets will be converted into cash for the home office and the current rate is the best measure of the amount of cash which will be received from them.

Current liabilities should also be converted at the rate current at the date of the statement, because these liabilities are a deduction from the estimated proceeds of the current assets.

The inventory at the beginning of the period should be converted at the rate which was current at the close of the former period. At that date the inventory in question was a current asset and was converted at the then current rate. The inventory at the close of one period is the opening inventory of the next period, and this inventory should be taken into the

statements of the two periods at the same value. In order to accomplish this result the opening inventory should be converted at the rate which was used at the date when it was the closing inventory.

In regard to nominal accounts opinions differ, some accountants favoring the use of an average rate (average of the rates for the period covered by the statement), while others favor the use of the current rate at the end of the period. It would seem that consideration should be given to the question as to whether the profits have been transferred to the home office during the period and thus realized or whether the profits remain at the branch in the form of current assets.

If remittances have been made throughout the year, so that the profits have been converted into domestic cash at various rates during the year, it is preferable to use an average rate. If remittances have not been made and the profits are therefore represented by current assets at the branch at the end of the year, it would seem preferable to use the current rate. The profits will be the same in either case, because of the necessity of making an adjustment for exchange to bring the balance of the branch current account on the home-office books up to or down to the converted value of the net assets at the branch.

No. 5 (23 points): .

The A Company's balance-sheet at December 31, 1921, contained the following accounts:

Capital stock authorized	\$200,000.00
Unissued stock	30,000.00
Treasury stock (50 shares—par 100) cost	7,500.00
Surplus	20,000.00
Capital surplus (from appraiser's revaluation of fixed assets)	4,500.00
Premium on stock (issued at 110)	17,000.00
Reserve for sinking fund	35,320.00
Reserve for extension of plant	20,000.00

On the same date the B Company bought 90% of the outstanding stock at 170 and acquired the treasury stock and the unissued stock at 150.

Compute, for consolidated balance-sheet purposes, the goodwill arising from the transactions.

Solution: The goodwill is the excess of the purchase price of the stock over the book value at the date of acquisition. The first question to be faced, therefore, is what items to include in the book value at the date of acquisition. There are three items which require consideration. The reserve for sinking fund should be included because it is an element of surplus, set aside because of a contract with bondholders. The reserve for extension of plant should be included because it also is an element of surplus, set aside because of a financial policy.

But what about the capital surplus arising from revaluation? There may be a tendency to assume that this should be excluded because of the disfavor with which accountants look upon its inclusion in surplus. There are two ways of indicating why it should be included.

In the first place, assume that the holding company had purchased the assets instead of the stock and had taken up these assets on its own books. There is no question that it would have included this additional value in

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the fixed property accounts and not in the goodwill, assuming that the appraisal was a trustworthy one. Now the consolidated balance-sheet shows conditions comparable to what would have resulted from a purchase of the assets instead of a purchase of the stock.

In the second place, if the capital surplus item is omitted from the book value at acquisition, the book value will be smaller and the goodwill will be larger than if the capital surplus is included. On the other hand, the surplus on the consolidated balance-sheet will have to be correspondingly larger.

In comparing the book value of the acquired stock with the purchase price, it is necessary to deal with the book value after the acquisition by the holding company. That is, any premium paid by the holding company to the subsidiary affects the book value of the stock held by the holding company and hence affects the goodwill.

The net worth of the subsidiary after selling the unissued and treasury stock at 150, is computed as follows:

Capital stock		\$200,000.00
Premium on stock:		
Original issue	\$ 17,000.00	
Sale to holding company: 350 shares at \$50 premium	17,500.00	
Total	34,500.00	
Less premium paid on treasury stock purchases	2,500.00	32,000.00
Surplus		20,000.00
Capital surplus (from appraisal)	\$ 4,500.00	
Reserve for sinking fund	35,320.00	
Reserve for extension of plant	20,000.00	
Total book value of all stock outstanding		\$311,820.00
The B Company acquired:		
90% of the \$165,000 outstanding stock	\$148,500.00	
Unissued stock	30,000.00	
Treasury stock	5,000.00	
Total (or 91.75% of total issue)		\$183,500.00

The book value of the stock acquired was 91.75% of \$311,820.00, or \$286,094.85.

The price paid was:

To outside stockholders: $148,500 \times 1.70$	\$252,450.00
To A company: $35,000 \times 1.50$	52,500.00
Total price paid	\$304,950.00
Deduct book value of stock acquired	286,094.85
Goodwill	\$ 18,855.15

No. 6 (23 points) (ACTUARIAL):

A music house sells pianos on the instalment plan, receiving monthly payments. Pianos cost \$600.00 and are sold for \$900.00. Interest at 6% a year or $\frac{1}{2}\%$ a month is charged on unpaid balances of the purchase price. Income each year is computed by taking such a proportion of the total profit as the collections on principal during the year bear to the \$900.00 selling price. In addition, income is credited with interest collected and accrued during the year.

A piano is sold August 16, 1921. An initial payment of \$50.00 is received and the purchaser agrees to pay the balance in 30 equal monthly instalments, payable on the 16th of each month, beginning September 16, 1921. These equal monthly payments are to be applied first to the interest accrued during the month and second to the principal. As the interest will decrease each month, the payment on principal will increase.

(a) Compute the monthly payment to be made. (The present value of \$1.00 due 30 periods hence at $\frac{1}{2}\%$ per period is \$.8610297.)

(b) Set up a table with the following columns:

Date	Payments			Balance of principal
	Total	Interest	Principal	

Enter the payments received in August, September, October, November and December and show the balance unpaid at December 16, 1921.

(c) State the total credit to income during 1921, including profit on sale and interest.

Solution:

(a) Computation of monthly payment:

\$1.0000000

.8610297 Present value of \$1 at $\frac{1}{2}\%$ due 30 periods hence

.1389703 Compound discount

$\$.1389703 \div .005 = \$27.79406$ Present value of annuity of \$1

$\$850.00 \div 27.79406 = \$30.58$ Monthly payment.

(b) Table of monthly payments:

Date	Payments			Balance of principal
	Total	Interest	Principal	
				\$900.00
Aug. 16, 1921	\$50.00	.....	\$50.00	850.00
Sept. 16, 1921	30.58	\$4.25	26.33	823.67
Oct. 16, 1921	30.58	4.12	26.46	797.21
Nov. 16, 1921	30.58	3.99	26.59	770.62
Dec. 16, 1921	30.58	3.85	26.73	743.89
	<u>172.32</u>	<u>16.21</u>	<u>156.11</u>	

(c) Computation of total credits to income for 1921:

Since the profit is one-third of the selling price, and since \$156.11 has been collected on the \$900.00 principal or selling price, the profit for 1921 is $\frac{1}{3}$ of \$156.11, or \$52.04.

Interest totaling \$16.21 has been collected, and there is a half month's interest accrued on \$743.89, or \$1.86.

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The total income for 1921, from this sale, is therefore:

Profit	\$52.04	
Interest:		
Collected	\$16.21	
Accrued	1.86	18.07
Total	\$70.11	

CONSIGNMENTS AND SALES

Editor, Students' Department:

SIR: Being a subscriber of THE JOURNAL OF ACCOUNTANCY, I am asking your advice as to the entries necessary to record the following facts:

Suppose a corporation during July, 1920, sends out on consignment \$1,000.00 worth of goods. This \$1,000.00 represents the selling price. The goods were sent out on consignment with the idea of securing a good distribution of the goods before starting the advertising. A cash discount of 2% was offered on the invoices provided the bill was paid within 90 days, but the consignment was not due net until the advertising started.

Four hundred dollars less the cash discount of 2% or \$8.00 was received by the corporation from customers who expected the advertising to make good.

The advertising was delayed and did not start until January, 1921, so that the consignments were not due and payment was not asked until March, 1921.

As the actual cost of manufacturing the goods was only \$500.00, it is therefore desired that the accounts on the ledger reflect the consignment outstanding in cost value only, so as not to include in the 1920 business any profit on the consignment. The advertising starting in 1921 naturally sold the goods in 1921, so that the year 1920 did not receive any profit, and the accounts should have been on the ledger at manufacturer's cost instead of at the expected selling price.

Will you kindly favor me with the entries necessary to reflect the above facts as of December 31, 1920? When advising please let me have the entry necessary to adjust the accounts that were paid during 1921, also entry for those who discounted their bills at selling price during 1920.

Yours truly,

St. Louis, Missouri.

O. C. U.

Answer: It is plainly impossible to tell what entries to make to correct the accounts when no information is given as to the entries already made to record the transactions. All that can be done is to discuss the principles which must be given consideration in determining the entries.

In the first place, while the shipments are referred to as consignments it is not at all sure that they are consignments. The letter refers to a cash discount and states that "the consignment was not due net until advertising started." If this means that it is due net when the advertising starts, and that the goods must be paid for and can not be returned, the transaction is not a consignment. The delay in settlement is merely a peculiarity of the credit terms, and the shipments should be treated as sales.

Assuming that the shipments really are consignments and that the consignees have the option of paying within ninety days and taking a discount or returning the goods or paying for them when the advertising starts,

the proper method of recording the shipments would be by a memorandum entry debiting consignments outward, which would be a controlling account with subsidiary accounts for each consignment, and crediting consignment sales. This entry may be made at cost or at selling price, though cost is preferable in order to keep track of the cost of unsold goods on consignment for inventory purposes.

When the consignee settles for the consignment, the memorandum entry should be reversed and a regular sales entry should be made. Now four-tenths of the goods have been sold and the consignment has to this extent turned into a sale. The fact that the advertising had not begun when collections were received merely means that the consignee may not have disposed of the goods, but the consignor has disposed of them and received payment for them and he should take up the profit. There is no more reason for him to wait until the advertising starts and the consignee disposes of the goods than there would be for a wholesale merchant to sell goods to a retailer and wait to take up his profit until after the retailer had also disposed of the goods.

As to the goods on hand in the possession of the consignees for which settlement has not been made, the consignment status still exists and these goods should be carried in the consignor's inventory at cost, \$300.00, which is 50% of the selling price of the goods for which settlements have not been received.

ARITHMETICAL PROGRESSION

Editor, Students' Department:

SIR: I have come across the following problem in my practice and have as yet been unable to solve it. Will you kindly publish your idea of the proper solution?

A building is to be leased for a term of 21 years at a total rental of \$525,000.00. The rental for the first year is to be \$10,000.00, with gradual equal increases so that during no year will the rental exceed \$30,000.00 and the rental for the 21st year shall be \$30,000.00.

Thanking you for your assistance in this matter, I am,

Yours truly,

New York.

J. S.

Answer: The terms of the problem are self-contradictory. Either the last rent must be more than \$30,000.00 or the total rent can not be \$525,000.00.

If the first rent is to be \$10,000.00 and the last one \$30,000.00, the principles of arithmetical progression can be applied to find the common difference or yearly increase. The formula to be used is:

$$D = \frac{L - F}{n - 1}$$

In which D = common difference or annual increase.

L = the last year's rent.

F = the first year's rent.

n = the number of years.

$$\begin{aligned}\text{Then } D &= \frac{\$30,000 - \$10,000}{21 - 1} \\ &= \$20,000 \div 20 \\ &= \$1,000.\end{aligned}$$

Students' Department

This would make the rent \$10,000.00 the first year, \$11,000.00 the second, and so on. But this will not produce the total rent of \$525,000.00, which may be proved by using another formula of arithmetical progression:

$$S = \frac{F + L}{2} n$$

In which S = the sum of all the payments.

Applying this formula, the total payments are computed as follows:

$$\begin{aligned} S &= \frac{\$10,000 + \$30,000}{2} 21 \\ &= \frac{\$40,000}{2} 21 \\ &= \$20,000 \times 21 \\ &= \$420,000 \end{aligned}$$

If the total payments are to be \$525,000.00, the last payment must be more than \$30,000.00, and the amount of this last payment may be computed as follows:

$$\begin{aligned} \text{Since } S &= \frac{F + L}{2} n \\ \frac{S}{n} &= \frac{F}{2} + \frac{L}{2} \\ \frac{S}{n} - \frac{F}{2} &= \frac{L}{2} \\ \frac{\$525,000}{21} - \frac{\$10,000}{2} &= \frac{L}{2} \\ \$25,000 - \$5,000 &= \frac{L}{2} \\ \$20,000 &= \frac{L}{2} \\ \$40,000 &= L \end{aligned}$$

The annual increase in rents may now be computed by the first formula:

$$\begin{aligned} D &= \frac{L - F}{n - 1} \\ &= \frac{\$40,000 - \$10,000}{20} \\ &= \$30,000 \div 20 \\ &= \$1,500 \end{aligned}$$

Then the rent the second year would be \$11,500.00; the third year \$13,000.00, and so on.

DIVIDENDS OUT OF CAPITAL

Editor, Students' Department:

SIR: Will you kindly give me an opinion on the following case? A company publishing a well-known popular magazine had issued stock for an equivalent amount of cash paid in. It suffered losses until its balance-sheet, in condensed form, appeared as follows:

Net capital and current		
assets	\$250,000.00	Capital stock \$300,000.00
Deficit	50,000.00	

Just about the time the magazine had reached this stage and its proprietors were greatly discouraged, it started to run a series of feature articles which suddenly became immensely popular. The circulation and advertising receipts suddenly jumped to figures previously unthought-of.

In the first year after this sudden change of fortune, the corporation earned profits of approximately \$40,000, and the directors desired to distribute dividends of \$30,000. But there was no surplus out of which to declare dividends. On the contrary, the balance-sheet still showed a deficit of \$10,000. In this predicament they called in an accountant who solved the difficulty by directing that a very simple entry be made on the company's journal, debiting a new account to be called "goodwill" to the amount of \$100,000 and crediting surplus for a like amount. Then the balance-sheet showed a surplus of \$90,000.

There was nothing then to prevent the immediate distribution of cash profits in the form of dividends.

Very truly yours,

Philadelphia, Pennsylvania.

H. W. S.

Nothing whatever. The only thing which might have prevented it was a little legal knowledge on the part of the directors, to the effect that a book entry debiting goodwill and crediting surplus does not create earned profits, and that they would become personally liable to creditors in case of future inability to pay the corporation's debts in full. Lacking this knowledge there was nothing to prevent the dividend. Some bitter experience as a result of this dividend might prevent a subsequent one in similar circumstances.

LOSS ON REALIZATION OF INVENTORY OF DISCONTINUED LINE

Editor, Students' Department:

SIR: May I ask your kind opinion in the following situation, which actually exists?

A concern making and selling one line of product (product A) and also formerly jobbing another line of product which it did not manufacture (product B) has discontinued altogether the sale of product B but continues the manufacture and sale of product A. At the time of the change in policy a \$2,000 inventory of product B, in salable condition, remained on hand. This inventory is still on hand and is carried as a separate ledger account. The nature of product B is such that sales are not likely to occur unless determined sales effort is made or unless expense is incurred, and no sales were made of product B. During the year the \$2,000 inventory of product B has suffered loss in value to the amount of \$500. This loss in value is credited to the inventory account in the ledger. The question is: How should the debit be classified?

Among the suggestions that have been made, and upon which I should like to have your opinion, are the following:

(1) Cost of goods sold (which aside from this item would consist altogether of items entering into the cost of product A).

(2) A part of "other gain and loss" at the end of the operating statement, with other items that affect net profit but are not considered a part of operations.

(3) Surplus.

Would your answer be the same if a number of sales of product B had been made during the year, it being understood that no expense or chargeable effort had been made to effect such sales?

The distinction between the case stated and the ordinary unsalable inventory items in a merchandising concern is that the inventory in the problem presented by this situation is the remnant of a line of product that has been altogether discontinued, and that so far as its physical condition is concerned the item is entirely salable.

I thank you now for such attention as you can give this inquiry.

Very truly yours,

Cincinnati, Ohio.

F. J. H.

It appears that the decrease in the value of the inventory of product B should be charged to surplus. The profit of the last period during which this product was dealt in has been credited to surplus; but the correctness of the profit thus credited to surplus is dependent upon the ability to realize the inventory at the value placed upon it when the books were closed at the end of the prior period. The loss now ascertained on the inventory is a correction of the value placed upon it at that time and is therefore a correction of the profits estimated at that time.

If sales of product B had been made during the period, it would appear that these profits would have been extraneous to regular operations since the company is no longer dealing regularly in product B. Therefore the profit on such sales would be an offset to the shrinkage in value of the inventory, and the net amount should be transferred to surplus as a net adjustment of the value placed upon the goods at the end of the last period during which they were regularly handled.

PARTNERSHIP PROFITS ON SALE OF CAPITAL INTEREST

Editor, Students' Department:

SIR: Enclosed is a copy of a problem that has been much discussed among the members of the staff during the past few days, along with the several solutions which have been offered during these discussions, and as a reader of the JOURNAL I shall appreciate it very much if you will comment on these solutions, stating under what conditions each would be correct.

Very truly yours,

Atlanta, Georgia.

T. W. B.

Question.

A and B purchase an invoice of cotton consisting of 200 bales for which they pay \$20,000. Of this amount A contributes \$12,500 and B contributes \$7,500. Later C offers \$10,000 for a one-third interest in this invoice, which A and B accept. You are asked to submit figures on which to base the distribution of this \$10,000; so that both A and B will receive absolute justice and that they may all continue equally interested in the venture.

Answers.

No. 1.

Withdrawal of original investment by A and B:

A—withdrawal	\$12,500.00 — \$6,666.67 =	\$5,833.33
B—withdrawal	7,500.00 — 6,666.66 =	833.34

Premium on sale of $\frac{1}{3}$ interest to C:

\$10,000.00 — \$6,666.67 = \$3,333.33	
A—50% of \$3,333.33	1,666.67
B—50% of \$3,333.33	1,666.66

Total distribution of \$10,000.00 paid by C:

	Capital	Premium	Total
A	\$5,833.33	\$1,666.67	\$7,500.00
B	833.34	1,666.66	2,500.00
Total			<u>\$10,000.00</u>

No. 2.

Withdrawal of original investment by A and B:

A—withdrawal (as above)	\$5,833.33
B—withdrawal (as above)	833.34

Premium on sale of $\frac{1}{3}$ interest to C = \$3,333.33 as above.

A— $\frac{5}{8}$ of \$3,333.33	\$2,083.33
B— $\frac{3}{8}$ of \$3,333.33	1,250.00

Total distribution of \$10,000.00 paid by C:

	Capital	Premium	Total
A	\$5,833.33	\$2,083.33	\$7,916.66
B	833.34	1,250.00	2,083.34
Total			<u>\$10,000.00</u>

No. 3.

Withdrawal of original investment by A and B:

A—withdrawal as above	\$5,833.33
B—withdrawal as above	833.34

Premium on sale of $\frac{1}{3}$ interest to C—\$3,333.33 divided

50 cents on each \$1.00 withdrawn.

A—\$5,833.33 $\times$.50	\$2,916.67
B—\$ 833.33 $\times$.50	416.66

Total distribution of \$10,000.00 paid by C:

	Capital	Premium	Total
A	\$5,833.33	\$2,916.67	\$8,750.00
B	833.34	416.66	1,250.00
Total			<u>\$10,000.00</u>

The above problem, submitted by T. W. B., cannot be solved with any certainty because there is no statement as to the ratio in which profits are to be shared. If profits are shared equally, the first solution is correct. If they are shared in the capital ratio, the second solution is correct. In the absence of an agreement, partnership profits are shared equally; therefore, in the absence of a stated agreement, the first solution must be assumed to be correct. I can not see that the third solution would be correct in any circumstances.

SELF INSURANCE

Editor, Students' Department:

SIR: I am a subscriber to your periodical and have followed from month to month the discussions of various items on accountancy, but have failed to find any explanation of the insurance-reserve account, which I understand is kept by several large concerns in the east.

Students' Department

In order that you may pass on it properly, I shall place a set of facts before you and ask you to outline the most feasible method of handling the proposition.

A corporation proposes to carry 50% of its insurance on stock, buildings and fixtures, at the same time creating a reserve on the books of the company which in time will cover any loss that might occur over the amount purchased.

To create this reserve, the company is going to transfer Liberty bonds to this account from the Liberty-bond account, and charge them at the prevailing market value, although the bonds are carried at par.

What entries will be required to set up this account for insurance reserve? Also what entries to cover loss on bonds?

Very truly yours,

X. Y. Z.

When a concern decides to carry so-called self insurance, there may be both a reserve and a fund. At any rate there should be a reserve; the fund is optional.

The reserve should be set up by a charge to profit and loss and a credit to insurance reserve. The amount charged to profit and loss may be determined in several ways, one of the most common being to set up the amount which would otherwise be paid as premium to an insurance company. Some concerns reduce this amount somewhat, on the theory that the premiums paid to an insurance company include the cost of the insurance and a profit, and since the object of carrying self insurance is to save this profit, the charge to profit and loss is reduced to the estimated cost of the insurance eliminating the estimated profit. Another method is to ignore the cost of premiums and compute the reserve on the basis of estimated future losses from fire. This is a very difficult method to apply as fire experiences of the past are an untrustworthy indication of probable losses in the future. When a loss occurs, it is charged against the reserve. In the case mentioned in the letter, where some insurance is carried with insurance companies, only the excess of the loss over the settlement recovered would be charged to the reserve.

If desired, the concern may also provide a fund to replace assets destroyed. This is accomplished by debiting the insurance-fund account and crediting the account of the asset transferred to the fund. Your statement that the reserve is created by transferring Liberty bonds to a reserve account must be incorrect because a reserve is an account with a credit balance. It would be impossible to transfer assets from one account to another and have the second account a reserve with a credit balance. It must be the intention to create a fund. There is a good deal of confusion between funds and reserves, and the mistake in terminology is not unusual.

If Liberty bonds are transferred from the bond account to the fund at a reduced value, debit insurance fund at the market value, debit surplus for the loss taken, and credit Liberty-bond account for the carrying value of the bonds transferred.

ESTIMATING PROFITS BY MONTHS

Editor, Students' Department:

SIR: I shall appreciate it if you will inform me how you would divide profits of an amount of \$100,000. The partnership contract between A, B,

C and D provides that the profits and losses should be divided as follows: A 40%; B 30%; C 24%; D 6%. Profits for the months of January and February, however, should be divided at the rate of 45% for A and 19% for C.

The bookkeeper of the firm takes the point of view that the total profit of \$100,000 should be divided equally over the twelve months of the year and the proportion thereof for the months of January and February should be shared by A 45% and by C 19%. The accountants who audited the books decided that this was an error and the profits of the first three months should be taken as a basis and that two-thirds of this amount represent the profit of the first two months, to be divided at the agreed rates.

Yours truly,

A. W. E.

The auditors are more exact than the bookkeeper, but I believe it is possible to be even more exact, and in a case of this sort, where financial interests of different parties are involved, the computation ought to be as exact as possible. As the auditors propose to use the profits of the first three months as a basis, it must be that the books were closed at the end of March. Therefore the rate of gross profit for these three months can be ascertained. Using this rate of gross profit, it is easily possible to ascertain the approximate inventory at the end of February by the customary gross-profit method. This ought to be a close approximation, as the rate used is the actual rate of profit for the two months involved, modified only by any change which may have occurred in March, which would probably have little effect on the computation. The books will show the purchases and sales for the two months, and with the actual inventory at the beginning of the period and the estimated inventory at the end of the period the gross profit for the two months can be very closely estimated. All that would remain is an analysis of the expenses to determine those which are applicable to the two months in question.

The auditors' proposal overlooks the fact that the profits for January and February might not be anywhere near two-thirds of the profit for the first three months, because of differences in sales and in expenses.

ADJUSTMENT OF PARTNERSHIP PROFITS

Editor, Students' Department:

SIR: Will you kindly give me your solution of the following problem:

A partnership, A and B, has interest in capital and profits for the year 1919 of 75% for A and 25% for B. A customer's account of \$1,000 is charged off during that year which results, of course, in A losing \$750 and B \$250.

The same partnership is upon the basis of 50% and 50% the next year, and the supposed bad account of \$1,000 is paid in 1920.

Should that collection when received be credited to surplus, in which case A and B would receive \$500 each although it had cost A \$750 and B \$250 the year before?

I do not seem to find any authority on this question and if you can refer me to such authority as has been printed, will you kindly do so?

Yours very truly,

Boston, Massachusetts.

H. H. S.

The collection could not well be credited to surplus because it is not customary for a partnership to have such an account. All profits are

divided at once. The question is: Should the collection be credited direct to the partners' capitals in the former ratio or be credited to profit and loss and thus be divided in the new ratio? Theoretically, there seems no question that the only equitable method is to credit the capitals direct in the old ratio. Otherwise A would suffer an injury as the result of a mere book entry. Practically, it might be difficult to apply this theory in all cases, for it might be impossible to ascertain all corrections of prior years' profits as easily as it is done in this case.

In support of the theory stated above, and in compliance with your request for reference to authorities, I am able to quote from an article by Mr. Walton which seems to be directly applicable:

"When the profit-and-loss ratio changes from one period to another, any adjustments of the profit of a prior period must be carried to the capital accounts in the profit-and-loss ratio of the prior period instead of in the ratio of the current period. To illustrate, if the profits of one period are understated, for instance by the understatement of the final inventory, when the error is discovered in a subsequent period correction must be made by credits direct to the partners' capital accounts in the prior year's profit-and-loss ratio. Correcting the error by a credit to profit-and-loss would be wrong for two reasons: first, it would overstate the current period's profit; and second, of much greater importance, it would distribute the profit in an incorrect ratio.

"If a reserve has been set up to meet a future contingency and the contingency has ceased to exist, the reserve should be credited to the partners in the ratio of the division of profits that prevailed at the time the reserve was created, and not in the ratio of the current year, if the rate has been changed."

This seems to cover the point. If a reserve had been set up against the account and later was found to be unnecessary, it should be closed back to the partners in the ratio which existed when the reserve was set up. The fact that the account was actually charged off does not change the principle.

FEDERAL TAXES AND BONUS

Editor, Students' Department:

SIR: I have read with interest the answer to many knotty problems in the JOURNAL, and I am wondering if you can advise me on the following:

"A" was the manager of several departments in a store and had an oral agreement with the president that in addition to his salary he was to get 10% of the profit of those departments. No data are available to show if there was any other qualifying condition as to how the profit was to be figured. Now the corporation submits him a statement giving the results of the year's business and in this statement his departments have been charged with a proportion of income tax paid to the government. Now the question in my mind is whether this tax paid to the government is a fair charge against his departments or it is proper to charge it against surplus, pure and simple. Just what would be the correct way to treat this item, and what is the usual way of handling it?

Very truly yours,

Walla Walla, Washington.

G. J. P.

A is to receive a percentage of the net profits; the net profits are not known until all expenses have been deducted; taxes are an expense; therefore it is the opinion of this department that it was proper to deduct a portion of the income tax from the profits of the departments in which

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the manager was interested. The mere fact that the expense of taxes is computed on the basis of profits before deducting taxes does not change the fact that the taxes are an expense.

Since the tax is based on profits, the proper way to apportion the tax among the several departments is on the basis of the profits of the departments.

It is announced that the name of the Incorporated Institute of Accountants, Commonwealth of Australia, has been changed to Commonwealth Institute of Accountants.

Hurdman & Cranstoun announce the removal of their offices to the Borden building, 350 Madison avenue, New York.

Lybrand, Ross Bros. & Montgomery announce the removal of their New York office to 110 William street.

Abadie, Burgess, Hessenbruch & Tanner announce the removal of their New York office to 50 Church street.

Courter, Rhyne & Shenton announce the removal of their offices to 30 Church street, New York.

E. A. Ashdown & Co. announce the removal of their offices to 120 west 42nd street, New York.

Alfred Rose & Co., New York, announce that they have admitted David Munroe to partnership.

Herbert S. Greenwood announces the removal of his office to 2 Rector street, New York.

David Elder & Co. announce the removal of their office to 34 Pine street, New York.

Leon Brummer announces the removal of his office to 53 Park place, New York.

Eckes & Dean announce the removal of their office to 40 Rector street, New York.

Joseph N. Tropp Co. announce the removal of offices to 165 Broadway, New York.

Terminology Department

CONDUCTED BY THE SPECIAL COMMITTEE ON ACCOUNTING TERMINOLOGY
OF THE AMERICAN INSTITUTE OF ACCOUNTANTS

The Committee on Terminology of the American Institute of Accountants, having prepared a tentative vocabulary in a form convenient for the use of its members, is now engaged in drawing definitions and desires to secure the coöperation and assistance of members of the profession and other readers of the JOURNAL.

Inasmuch as the terms used in balance-sheets and profit-and-loss statements form the basis of the language of accountancy, these terms are of the first importance and will receive the first consideration. It is intended to arrange these words in small groups, each group containing words which are more or less synonymous, and to consider them group by group. First there will be considered groups of base-words such as "profits" and, when definitions have been tentatively accepted, the derivative words such as "gross profits" and "net profits" will be considered. It is proposed to publish from time to time the tentative results at which we arrive and to ask our readers to forward any suggestions or criticisms they may care to make, whether these be different from or agree with the conclusions reached by us.

Our work has been greatly facilitated by the able coöperation of the librarian of the institute who has collated for us from various sources definitions of the words in our vocabulary. These definitions number many thousand and bring out clearly the meanings assigned to any word by recognized authorities. They are studied by the committee before preparing its own tentative definitions, some of which are now submitted.

Before studying these in detail it is well to consider certain general principles which are involved and will demand consideration throughout the work.

In the first place, it will be found that in many cases the correct definition of a word depends upon the subject with which it is used. While there are frequently colloquial or technical meanings with which accountants are not now concerned, there are three branches of science in which they are interested, viz., accounting, law and economics. Generally speaking, it will be possible to find a common definition which will satisfy accountants and will be accepted by lawyers. The economist, however, often requires an entirely different definition and, as accountancy and economics are so closely allied, it seems wise in some cases to give separate definitions.

The second general principle is concerned with the best method of treating those words which are used by accountants so indiscriminately that they have become almost synonymous. Typical of such words are "earnings," "gains" and "profits"; in fact, the dictionaries define "earnings" as "gains" and "gains" as "profits."

This leads to the question: Shall such words be treated as synonyms, using one definition broad enough to cover all meanings, or shall we attempt to assign to each some particular interpretation or idea?

The committee feels that the first course leads to an unnecessary impoverishment of the language, to the throwing away of a goodly heritage. It feels, too, that each word has its individuality and conveys some idea, some shade of meaning, different from any other word. It will, therefore, endeavor to bring out the individuality of each word, thereby enriching the vocabulary and rendering possible shades of meaning and more definite, accurate description than could otherwise be attained.

If these principles be applied to the first group consisting of "earnings," "gains" and "profits," an examination of the accepted definitions brings out the following:

EARNINGS:

The prevailing idea here is the reward for services performed, usually a pecuniary reward for services rendered without the aid of capital.

GAINS:

This includes increment of amount or degree; that which is acquired or comes as a benefit, profit or advantage as opposed to a loss.

The word usually carries the idea of comparison—"Current profits show a gain over those of last year" or a "gain in speed, weight or earning power."

The second meaning of the word is less used now than formerly. "Profit-and-loss" account largely replaces the "loss-and-gain" account.

PROFITS:

This word implies that which remains—is left over—after defraying expenses and providing for loss of capital.

In view of the above, the following definitions are suggested:

EARNINGS:

That which is gained or merited by labor, service or performance; reward; wages; compensation.

The word implies the reward of personal effort, as distinct from return upon investment, e. g., in the expression "earned income" or "unearned income." The word is applicable to individuals rather than to corporations although as applied to the latter it is used by virtue of tax laws synonymously with "income."

In economics the word means the return of any economic good for an economic service and is applicable to supervisory services as well as productive labor.

GAINS:

Increment of amount or degree; that which is acquired or comes as a benefit, profit or advantage as opposed to a loss.

PROFITS:

The gain resulting from the employment of capital in any undertaking; the excess of the selling price over the cost of anything; pecuniary gain in any transaction or occupation. The surplus remaining from the employment of capital after defraying expenses and providing for loss of capital employed.

In economics the term "profit" is used to designate the net return left in the hands of a producer after deducting wages, including normal wages of management, rent, the value of materials consumed and fixed capital

expired, normal interest on capital, whether borrowed or owned by the producer, and a sum sufficient to insure against risks. Any surplus remaining due to unforeseen price fluctuations, etc., to fruitful inventions or to exceptionally successful management is profit.

Let us now consider a second group consisting of

INCOME
RECEIPTS
REVENUE

INCOME:

The word expresses the idea of that which has or will come in from any source (excluding a return of capital).

When applied to the affairs of individuals it expresses the same idea as revenue does when applied to the affairs of a state or municipality. It implies cash or its equivalent and is derived according to economists from four sources, viz.:

LAND
CAPITAL
LABOR
BUSINESS ORGANIZATION

RECEIPTS:

These may come from any source, but there is always conveyed the idea of *un fait accompli*—the word means only that which is actually received and, unless qualified in some way, indicates cash.

REVENUE:

The derivation of this word, whether taken from the Latin or the French, indicates the original meaning which has remained unchanged. The word still means a coming back, that is, the return for something put out or invested.

"Revenue" is used by public utilities in conjunction with operating income, but with this exception the word is generally used in the accounts of states and municipalities to indicate the items which could appear under "income" in the accounts of a corporation or individual.

The following definitions are suggested:

INCOME:

Income is increase in wealth measured in terms of money, accruing or received during a given period, and results from the use of capital or the rendering of personal service or both as distinguished from the return of capital. It includes earnings, gains and profits from any source.

In economics "income" means the totality of the advantages enjoyed by a given community, either in the form of goods or services, during a stated period, as a rule one year, as opposed to the totality of goods in existence at a given moment.

RECEIPTS:

That which is actually received, indicating cash (from all sources) unless otherwise described.

REVENUE:

Income of a government derived from taxes, customs or other sources; also used with respect to the operating income of public utilities.

The committee urgently requests criticism on the above. Communications may be directed to any one of the undersigned.

WALTER MUCKLOW, *chairman*,
420 Hill Building, Jacksonville, Fla.

EDWARD H. MOERAN,
120 Broadway, New York.

J. HUGH JACKSON,
56 Pine Street, New York.

American Institute of Accountants

REGIONAL MEETING AT BOSTON.

The fourth regional meeting of the New England members of the American Institute of Accountants was held June 5, 1922, at Norumbega Park, Auburndale, Massachusetts. The meeting was called to order at 11.15 a. m. by Alfred P. Ward, chairman, one hundred and sixty-two members and friends being in attendance.

The report of the regional secretary was read and accepted.

At the morning session the following addresses were read and discussed: *The Theory of Business Cycles*, by Ralph B. Wilson; *Present Day Problems in Industrial Accounting*, by Stanley G. H. Fitch; *The Accountant and the Promoter*, by Frederick J. Hillman.

In the afternoon there was a ball game between teams representing Rhode Island and Massachusetts, the latter team winning by a score of 14-4.

The evening entertainment consisted of an informal dinner at 6.00 p. m., at which short addresses were made by Percy A. Guthrie, Charles L. Talbot and A. P. Richardson.

After dinner, the members and guests attended the open air theatre in the park.

E. Q. Kruchten, H. W. Muench and N. E. Tessem announce the formation of a partnership under the firm name of Edward Q. Kruchten & Co., with offices at 111 west Monroe street, Chicago, Illinois.

Bruce W. White announces the opening of an office in the Walker building, 17 south Eighth street, Minneapolis, Minnesota.

Frederick B. Hill & Co. announce the opening of an office in the First National Bank building, Rocky Mount, North Carolina.

J. E. Graef & Co. announce the removal of their office to 55 John street, New York.

Ludwig B. Prosnitz announces the removal of his office to 1270 Broadway, New York.

Book Reviews

BUSINESS ORGANIZATION AND ADMINISTRATION, by J. ANTON DE HAAS. *The Gregg Publishing Co.*, New York. 353 pp.

Dr. de Haas, who is professor of foreign trade at New York University, has given us an admirable little text-book for a short course in the fundamentals of business administration, organization and management. It is, of course, merely a bird's-eye view of business as a whole, but it affords a basis for thorough grounding from which the student may proceed intelligently to more specialized and advanced courses. It is by no means superficial, however, for it contains a wealth of detailed information on every subject it touches from the proper organization of a complicated business, financing an enterprise (two very keen and lucid chapters on this), the problems of management and the wage question to selecting location, planning factory and store buildings, purchasing, selling and advertising, with closing chapters on methods used in foreign trading.

The closing paragraphs of each chapter summarize briefly and clearly the important points discussed in the chapter, a feature not often found in text-books and a most useful one. For reference and collateral reading there is also appended to each chapter a selected list of books usually to be found in the libraries of business schools and colleges, another feature which should be as valuable to teachers as to students.

A thoroughly sound bit of technical work on which the author is to be congratulated.

W. H. LAWTON.

SERIAL BOND MATURITIES, by ARTHUR S. LITTLE. Published by the author, St. Louis. 63 pages.

Serial Bond Maturities deals with the problem how to pay off an issue of bonds over a period of years by means of a uniform amount set aside each year, out of which the maturing coupons are paid first, the balance to provide the required sums to retire the bonds themselves within the stipulated period.

The principal part of the booklet consists of thirty-six one-page tables. The first table covers the retirement of an issue in five instalments, the second in six instalments, etc., up to forty instalments. Each table covers rates that range from four to seven per cent. and increase by one-quarter of one per cent. Each table further shows the percentages or "key numbers" that are to be applied to the total of the bonds to be retired and these percentages or "key numbers" vary with the rate of interest payable on the bonds. The "key numbers" are given for "first" and "last maturities," i. e., by applying them to the total amount of the bonds to be retired they will produce the amount of principal that will be paid in the first and in the last period.

In the preface and appendix several examples are given showing how the intervening maturities may be calculated, either by means of an adding machine or by "pencil and paper multiplication," and several time-saving devices are given or suggested.

The booklet is designed for serial issues that fall due at annual intervals and that remain within the *aforedescribed* limitations as to number of instalments and rates of interest, but mention is also made of semi-annual maturities and unusual rates or denominations. In these cases the use of other bond tables is recommended.

Evidently the booklet is designed for those who are not familiar with the use of compound-interest tables. It is questionable, however, whether the specific methods outlined in the former will be more easily understood by the average banker, business man or clerk than the more general methods given in the latter. Without the slightest doubt the method called for by the interest tables is by far the simpler, provided one knows how to use them.

The principal difficulty that presents itself to the average layman when confronted by such a problem is how to state the problem in terms that themselves will give a lead to its solution. The one in hand could be approached in the following manner:

- (a) If the bonds (totaling, say, one dollar) were to mature at one date (say in forty years), their amount with compound interest to that date (say at six per cent. per annum) could be at once determined by consulting the interest tables, (\$10.28572).
- (b) If annual instalments (say of one dollar each) were to bear compound interest to the end of the same period (forty years) at the same rate (six per cent.) their amount at the end of that period could also be determined at once, (\$154.76197).
- (c) The "amount" of a certain number of bonds as computed under (a) will of necessity be equal to the "amount" of the required instalments as computed under (b) for the reason that the latter are to pay off the former and the two must therefore be equivalent.

In the above case the problem resolves itself into the following:

- (d) What annual instalment will at the end of forty years produce \$10.28572 if interest is compounded annually at the rate of 6%—
\$10.28572

$$\text{Answer: } \frac{\$10.28572}{\$154.76197} = \$0.066461547$$

or: 6.6461547% of any issue of forty-year six per cent. bonds (the coupons payable annually) set aside annually for forty years will pay the interest and principal of these bonds.

After determining the annual instalment, it may for all practical purposes be rounded off to the next (higher) even hundred and it will then be a simple matter to prepare, usually without the help of adding machine or "pencil and paper" calculations, a schedule somewhat of the following columnar arrangement:

Coupon date
Bonds outstanding
Annual instalments
Coupons payable
Available for retirement of bonds
Bonds retired
Unexpended balance

that will give not only the maturities but also the coupons payable and on the whole will show more completely and in a more convincing manner the various aspects of the solution.

It is, of course, possible that it is asking too much of the average business man to be or to make himself familiar with the use of interest tables, but it does not seem as if the procedure indicated in the booklet will be more easily mastered. Accepting its "raison d'être" it would still seem, however, that the booklet would serve a more practical and more general purpose if the tables would show interest rates ranging from one to eight per cent., the rates increasing by one-eighth of one per cent. and for a larger number of instalments. They would then be serviceable for semi-annual and quarterly redemptions which are often met with in other than municipal loans. A. VAN OSS.

FEDERAL INCOME-TAX LAWS, by BARTON and BROWNING. *John Byrne & Co.*, Washington, D. C. 450 pp.

This book is a unique contribution to the literature concerning our complex income-tax law situation. It is essentially a law book, but it is prepared in such a way that any person at all familiar with legal terminology and the method of citing cases can put it to practical use. Its unique features are that it includes all of the tax laws since the first one in 1861, each law is annotated with foot-notes giving brief digests of the points of the cases, and the last six laws are printed in six parallel columns so that the sections are correlated. This last feature is important in the preparation of briefs or of a case on appeal. While the plan of correlation necessarily throws some sections out of their natural order, the arrangement is not at all confusing and it is most helpful to find similar topics as treated by the various laws stated so that they are all before the reader at the same time.

The book contains also all of the miscellaneous acts, provisions of the constitution of the United States and of the revised statutes of the United States which concern these various income-tax laws. It is well indexed and it has a table of cases arranged alphabetically and another one arranged by citations in numerical order. In the annotations the authors do not express opinions but merely digest the cases cited. This volume should prove particularly useful with other income-tax books in which the authors comment upon the law and upon the cases under it. In the annotations the only cases digested are those which arose in the federal courts. HAROLD DUDLEY GREELEY.

EVERYDAY USES OF ENGLISH, by MAURICE H. WESEEN. *Thomas Y. Crowell Co.*, New York, 1922. 447 pp.

Is it because we are growing careless in our use of language or because we begin to know our shortcomings that there is so abundant a supply of new books telling us what to say and how to say it? It seems to be one of the favorite activities of the publishing trade to induce someone to say something on the subject of English and then to offer his lucubrations to a rather indiscriminating public. The man who can write absolutely correct English, French, Italian or

other language of civilization is yet to be born. Even our so numerous grammarians wander far from the paths of exactitude, and for that reason some of us are apt to say that when the doctors disagree the rest of us may be forgiven if we err. Nevertheless, there is so much utterly unpardonable error in our common speech that it may be permissible to send forth a liberal mission to reform us. The great trouble is that it is so easy to find flaws in many of the reformatory texts. In *Everyday Uses of English* there are many things to which some authors and also some profane persons would dissent. In the matter of punctuation much could be said in opposition to the author, Professor Maurice H. Weseen. (We know full well that punning is a pastime of obliquity, but the temptation is irresistible to hazard the guess that an author with so ungrammatical a name was driven to a passion for correct diction.)

It is, however, when we come to the consideration of business letters that we are principally at outs with our author. We grieve to find that one who condemns so harmless and useful an expression as "attached hereto" or "enclosed herewith" gives the sanction of his approval to business letters containing such atrocities as

"If you are connected with a bank or are thinking of becoming connected with a bank."

"We have no hesitancy in guaranteeing satisfaction."

"If the suggestion just offered is satisfactory to you, wire us at our expense to proceed with your order and then follow, at your convenience, with the financial statement."

"Meanwhile, we stand ready to give your orders prompt attention on our regular standard terms. We shall also be glad to render you any service that we possibly can."

"We shall anticipate your reply with the greatest confidence."

If we were to review the book before us through the spectacles of a purist there would be much more to be said. Purism, however, is not to be expected in every-day English, and the author may be forgiven for not attempting it.

There is much in the book that is good, and the matter is presented in a pleasing, conversational way which will make reading easy. It is far from perfect, but we shall be satisfied when all the members of our staff attain to an equal proficiency in English. A. P. R.

Escott & Barnett announce the admission to partnership of H. E. Baumgarten, Wade H. Habitt and Clifton R. Escott. The firm hereafter will practise under the name of Escott, Barnett & Co., with offices at 501 Columbia building, Louisville, Kentucky.

Marwick, Mitchell & Co. announce the removal of their accounting offices to the Lords Court building, corner of Exchange place and William street, New York.

Alexander Aderer & Co. announce the opening of an office at 84 St. Paul street, Rochester, New York.

Current Literature

Compiled in the Library of the American Institute of Accountants

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The JOURNAL of ACCOUNTANCY

Official Organ of the AMERICAN INSTITUTE OF ACCOUNTANTS

Vol. 34

AUGUST, 1922

No. 2

Stockbrokers' Accounts

By GOULD MCINTOSH

While the principles of stockbrokers' accounting are simple enough and the ascertainment and verification of the financial position of stockbrokerage houses easy, the subject is so surrounded with mystery that a deplorable lack of understanding of stockbrokerage accounts exists among accountants, and especially among both the legal profession and the public at large. This lack of understanding, especially on the part of the latter two classes, has been emphasized during the existence of the unfortunate conditions arising from the recent numerous failures of Wall-street brokerage houses and at present there is a widespread demand that the public be better protected in its dealings with stockbrokers. As a result thereof, on May 11th the New York curb market, following the adoption of a similar ruling by the New York stock exchange, adopted this resolution:

"Resolved, That regular and associate members of the exchange and firms registered thereon having deposit liabilities or carrying margin accounts for customers or other members of the exchange shall furnish to the committee on complaints, at the request of said committee, a financial statement of the condition of such member or firm, in such form as shall be prescribed by the committee, and that such statement may be called for in the discrimination of the committee at any time and shall be called for not less than twice in each calendar year."

On the same day, Seymour L. Cromwell, president of the New York stock exchange, during the course of an address to members of the Philadelphia stock exchange, said:

"I sometimes feel that brokers and their business are enshrouded in too much mystery and misunderstanding. There is a crying need for the interpretation of the stock exchange to the public. Mystery begets suspicion and distrust, and until we find a way to give the public a proper understanding of our institution so long will we encounter hostility born of ignorance."

It has even been urged by the New York district attorney that the exchanges should be incorporated and that stockbrokers should

be controlled by a licensing system. In expressing his opposition to the promulgation of such laws, Mr. Cromwell said:

"I believe that the New York stock exchange has but one great obligation, and that is its obligation to the public. I believe, and I shall believe until I am persuaded otherwise, that the obligation to the public can be best discharged through the continued ability of its governing committee to exercise power commensurate with its responsibility to the public.

"I believe that the one enemy that the bucket-shop really fears is the stock exchange; that the only effective work done against the bucket-shops has for many years been done by the stock exchange; that we are the last bulwark against these swindlers of the public; that if political control is injected into the situation such a condition as exists today in Montreal will exist in New York and spread throughout the country.

"In Montreal in an incorporated exchange, working really under the old Napoleonic code, an attempt to discipline members for fraud is a farce: members are fined and do not pay; members take into partnership with them people of bad reputation and the exchange is helpless to prevent it.

"Who can there be really to believe that the sinister power which in times past brought such enormous profits to a vicious political ring, through the control of gambling houses, race tracks and liquor interests, would not in the same way bring vast profits to them also through their taking over the control of a legitimate business like the New York stock exchange, through interference with the authority of its officials dragging it down to the same plane as that of many of the outside brokers, who, after all, are on a par with the 'easy money' business that separates the public from its money?

"What are the qualities of the stock exchange which must be so jealously guarded? First, that it is the one great organized market. Second, the stock exchange is conceded to be a standardizer of values and thus takes rank as a creative agency for business through continually bringing investors in touch with market opportunities. Third, the exchange provides immediate negotiability for the greater part of the nation's investments. The American stock and bond certificates listed on the New York stock exchange are estimated to represent more than one-fifth of the wealth of the United States, which thus becomes a liquid asset.

"The bills against the passage of which the exchange has protested would have thrown open the dealing in securities practically unmolested to those very people we feel should be ruthlessly driven out of business. The very politicians who claim to have the same object in view would be granting personal licenses to brokers at a nominal cost, practically giving them a badge, which would carry with it in the minds of the public a guaranty of honesty from the state."

Citing the recent bankruptcy of a firm, which failed owing its customers \$4,000,000, Mr. Cromwell declared that after the exchange had removed its ticker from the firm's offices, prior to the failure, politicians of all ranks and of various parties seemed suddenly to rally to the defense of these men.

"Is this not evidence," he asked, "that these very people against whom the law would have been aimed could easily have obtained a license?

"It comes back to the old idea," he added, "that it is impossible to create character by legislation; and a leveling down of the standards of honesty would be a sure result of the licensing of individual brokers."

Without entering into a general discussion of these matters, the following epitome of stockbrokerage accounts will show that, in the last analysis, the financial position of a stockbroker is dependent upon the extent of his capital remaining in his business and the relation thereof to the condition of his customers' margins. Inasmuch as the margin condition varies with market fluctuations and is therefore of only momentary significance, it follows that in order to place stockbrokers upon a basis similar to that of insurance companies or banks it would be necessary to require brokers to maintain a reserve or capital in their business governed, in amount, by the volume of and ratio between customers' balances and margins.

To a large extent this amount of capital or reserve has been required and fixed by the nature of stockbrokerage itself. The business is conducted between brokers on a spot cash basis whereby no securities are delivered until payment is made. Thus the broker is required to finance the difference between the amount of his customers' equities (i. e., the excess of the amounts of customers' commitments over their deposits or margins) and the amount which he is able to borrow from banks against his customers' margined securities (usually about 80 per cent. of their market values), although it is worthy of note that brokers in a weak cash position lend stock on the "floor" whereby they receive approximately 100 per cent. of its value. And it is thus that the broker's stability becomes contingent either upon his customers' maintaining their equities or upon the adequacy of his own capital to absorb the losses of such of his customers as fail to make good their equities. Further than this a legitimate broker does not speculate—that being the business of his customers. Obviously it is the broker's duty to ascertain the financial responsibility of his customers and the customer's duty to inform himself as to the broker's condition. Inasmuch as brokers do not publish their accounts and only seldom have independent examinations made of their financial position, it is necessary for customers to rely upon the general reputation of the broker—which, unfortunately, is generally flattering up to the time of failure.

Inasmuch as the legitimate business of a stockbroker is merely in consideration of fixed commissions to buy and sell securities for the account and risk of his customers and to assist customers in financing their transactions through borrowing from his banks

against customer's securities as collateral (for which service customers are charged with interest at rates in excess of those which the broker, in turn, is required to pay to his banks), their general books of account are simple ones (although unusual both in ruling and terminology) and comprise only a blotter and a ledger.

The blotter is the sine-qua-non of stockbrokerage accounting, and, being the only book of original entry, it serves as combination cashbook, sales book, purchase book, security register and journal. While the broker's ledger is in the same form as the ordinary ledger it is used for a double purpose, namely, to record both shares and money. That is to say, customers' accounts are credited with the margin which they deposit. If in cash their accounts are credited and cash account charged. If in securities their accounts are credited by a memorandum entry on the charge or left side of the ledger only, and a contra entry is made in the position book (a memorandum ledger containing accounts in quantities only for each security handled). Thus, it happens that securities appear on the left side of customers' accounts and represent securities belonging to the customer (i. e., his credit) and are posted to the position book as well, where they represent securities in the broker's possession. For instance, customers' accounts (1) are charged and credited, respectively, with money withdrawn and money deposited by customers and (2) charged and credited, respectively, with the money value of securities purchased and sold. It is obvious that upon charging a customer's account with the cost of shares purchased the shares themselves actually are a credit to the customer (i. e., they are his and he is "long") and, conversely, in crediting a customer's account with the proceeds of shares sold, the shares themselves are a charge against the customer (i. e., he hasn't them and he is "short"). Hence, the debit side for money is used as the credit side for securities and the credit side for money is used as the debit side for securities. Consequently, in brokerage accounting it is as necessary to balance securities as it is to balance money.

The first and all-important step in the audit of a stockbroker lies in thus balancing and confirming all securities. Immediately at the close of business or the date of audit, the auditor should

verify all securities in the broker's hands ordinarily comprising:

- (1) Securities "in the box," verified by count
- (2) Securities hypothecated for bank loans, verified by confirmation
- (3) Borrowed and lent securities, verified by confirmation
- (4) Securities out for transfer, verified by confirmation

The next step is to ascertain that the securities thus verified comprise all the securities that should be on hand. This is done by posting from the customers' statements the long and short securities in each account to cards or sheets so as to determine from statements themselves (which subsequently will be mailed by the auditor to customers for their confirmation) the quantities of each kind of shares, which should, of course, agree with the corresponding shares counted and confirmed.

While the subsidiary memorandum records maintained in support of the general ledger are usually found in a slovenly condition (this is also the case with the blotter) that detail is unimportant compared with the adequacy of the accounting methods adopted to control the amount of customers' margins as the market fluctuates and to control the movement of all incoming and outgoing securities. Each night securities are usually balanced against the position sheet whereon the position clerk has noted during the day all changes of securities (having a section blocked off on the sheet for each security) whether arising from changes in collateral, receipts from and deliveries to customers, securities borrowed and lent, etc. The changes are then noted in the position book and the amount of securities in the box is examined to see that they agree with the amount called for by the book. The margin clerk maintains a pencil record showing the amount owed by each customer and the up-to-the-minute values of the securities held by the broker as collateral. In addition to the position book and the margin book a loan book is maintained which lists the securities pledged as collateral to bank loans with notations of their current values. It is necessary for the broker to maintain collateral at all times up to a value of about 120% of the amount of his loans. Last, a transfer record is maintained to record securities sent to issuing companies

or their transfer agents for transfer. From an auditing standpoint it is usually necessary for the auditor to limit his certificate by stating that the recorded securities were found to be on hand, for it is generally impracticable to discover substitutions made by the brokers from fully paid securities left in trust with them for transfer or safekeeping. Such a practice, however, constitutes a felony.

As was mentioned above, it is usually best for the auditor to balance the securities by building up his own position record in the form of a set of 5 x 8 cards, using one for each kind of security carried, and provided with columns to list the "longs" and "shorts" in the customers' accounts and to summarize the securities verified by him as shown by his schedules for

Count of securities on hand (box count)

List of securities deposited as collateral to bank loans

List of securities borrowed and lent

List of securities out for transfer

Time is the essence of a stockbrokerage audit and while it is usual to find numerous accounts with blind names and that contractions of the official ticker abbreviations have been used by the broker's staff, it remains necessary that, during the night intervening between the close of business on the day of commencing the audit and the opening of business the following day, the auditor should mail statements to everyone, bankers, customers, other brokers, etc., having an account on the books showing the final balance in both money and securities and requesting them to mail confirmations thereof to him. The general accounting procedure in brokerage accounts and leading up to the preparation of a comprehensive balance-sheet is illustrated by the four exhibits attached hereto and filled in with hypothetical figures. The exhibits comprise:

Exhibit 1—Trial balance of general ledger accounts

“ 2—Trial balance and summary of customers' ledger accounts

“ 3—Statement security position

“ 4—Combined balance-sheet and statement of equities

Stockbrokers' Accounts

Exhibit 1

DOE AND ROE, STOCKBROKERS

TRIAL BALANCE 19....

Debits

Petty cash fund	\$ 500
Bankers' Trust Company	99,500
Customers' ledger (debit balances)	3,180,000
Borrowed stock	650,000
Failed to deliver	40,000
Seat	50,000
Furniture and fixtures	5,000
	\$4,025,000

Credits

Cash loans	\$3,000,000
Customers' ledger (credit balances)	810,000
Loan stock	5,000
Failed to receive	25,000
Capital	150,000
Undivided profits	35,000
	\$4,025,000

EXHIBIT 1—GENERAL LEDGER TRIAL BALANCE:

It will be noted that the debit and credit balances in the customers' ledger as shown by the trial balance of that ledger are transferred to the general ledger trial balance. It is not practicable to incorporate controlling accounts in the general ledger because of the form of blotter commonly in use.

The "failed to deliver" securities should be verified together with "borrowed stock" by obtaining confirmations from the brokers to whom the respective securities are owed and the "failed to receive" securities and "loan stock" require to be confirmed by the brokers who borrowed them.

DOE AND ROE, STOCKBROKERS
ANALYSIS OF CUSTOMERS' LEDGER ACCOUNTS

.....19....

Customers' names	Class of acc't	Securities		Ledger balances	
		Long	Short	Debit	Credit
Brought forward		\$4,498,500	\$298,000	\$3,103,750	\$484,950
H. J. Smith, short account... B			27,000		24,000
H. J. Smith, long account... A		100,000		75,000	
T. J. Jones	A		250,000		300,000
S. R. Brown	B	1,000		1,200	
S. B. Brown	C			50	
H. K. Wood	D	500			1,000
S. B. Wood	E				50
A. B. C.	F	50,000			
X. Y. Z.	G		1,000		
Totals		<u>\$4,650,000</u>	<u>\$576,000</u>	<u>\$3,180,000</u>	<u>\$810,000</u>
RECAPITULATION					
Debit or credit balances:					
Fully secured	A	\$4,000,000	\$300,000	\$2,800,000	\$350,000
Partly secured	B	250,000	275,000	375,000	260,000
Debit balances—without securities	C			5,000	
Credit balances—with long securities	D	350,000			140,000
Without securities or commitments	E				60,000
No cash balances—					
Securities held for customers'	F	50,000			
Short commitments	G		1,000		
Totals		<u>\$4,650,000</u>	<u>\$576,000</u>	<u>\$3,180,000</u>	<u>\$810,000</u>

EXHIBIT 2—ANALYSIS OF CUSTOMERS' ACCOUNTS:

This schedule is prepared by extending the securities shown in each customer's account at market prices, after which the accounts should be classified as follows:

Debit balances:	Securities	Money balances
With securities:		
Fully secured		
Partly secured		
Without securities		
Credit balances:		
With commitments:		
Fully secured		
Partly secured		

Stockbrokers' Accounts

Exhibit 3

DOE AND ROE, STOCKBROKERS

STATEMENT OF SECURITY POSITION

.....19....

	On hand		Customers short		Pledged		In transfer		Loan to brokers	
	Shs.	Amt.	Shs.	Amt.	Shs.	Amt.	Shs.	Amt.	Shs.	Amt.
Brought forward	6,200	\$545,000	6,336	\$576,000	33,000	\$2,890,000	484	\$44,000	330	\$30,000
U. S. Steel—com.	1,000	100,000	.....	.....	10,000	1,000,000	...	.....	...	.....
U. S. Steel—pfd.	500	55,000	.....	.....	1,000	110,000	...	.....	...	.....
	7,700	\$700,000	6,336	\$576,000	44,000	\$4,000,000	484	\$44,000	330	\$30,000

58,850 shs.—\$5,350,000

Customers long		Borrowed from brokers		Securities owned	
Shs.	Amt.	Shs.	Amt.	Shs.	Amt.
38,650	\$3,385,000	7,700	\$700,000	.....	.....
11,000	1,100,000	.....	.....	.....	.....
1,500	165,000	.....	.....	.....	.....
51,150	\$4,650,000	7,700	\$700,000	None	

58,850 shs.—\$5,350,000

EXHIBIT 3—STATEMENT OF SECURITY POSITION :

After the securities have been balanced by posting them from the customers' accounts to position cards and the box-count, borrowed, lent and other security counts have been posted and balanced, the quantities appearing on each of the cards should be listed on such a form as exhibit 3 and extended at their respective market values.

DOE AND ROE, STOCKBROKERS *Exhibit 4*
 COMBINED BALANCE-SHEET AND STATEMENT OF EQUITIES
19....

<i>Assets</i>		Market value of securities'	Ledger balances
Cash in banks and on hand			\$ 100,000
Customers' debit balances:			
With securities:			
Fully secured	(a)	\$4,000,000	2,800,000
Partly secured	(b)	250,000	375,000
Without securities	(c)		5,000
Advances on borrowed securities		700,000	690,000
Seat			50,000
Furniture and fixtures			5,000
Long securities held for customers, fully paid:			
With credit balances	(d)	350,000	
With no cash balances	(f)	50,000	
		<u>\$5,350,000</u>	<u>\$4,025,000</u>
<i>Liabilities</i>			
Cash loans (demand)		\$4,000,00	\$3,000,000
Customers' credit balances:			
With commitments:			
Fully secured	(a)	300,000	350,000
Partly secured	(b)	275,000	260,000
With long securities	(d)		140,000
Without securities or commitments	(e)		60,000
Deposits held against securities on loan		30,000	30,000
Capital			150,000
Undivided profits			35,000
Customers' short commitments with no money balance	(g)	1,000	
Securities on hand		700,000	
Securities in transfer offices		44,000	
		<u>\$5,350,000</u>	<u>\$4,025,000</u>

EXHIBIT 4—COMBINED BALANCE-SHEET AND STATEMENT
 OF EQUITIES:

This exhibit is prepared from the general ledger trial balance after spreading the customers' balances and security position from exhibits 2 and 3, respectively.

IN CONCLUSION

To the present time it has been common practice among stock-brokers to satisfy their requirements with a balance-sheet that comprises merely the balances after closing as shown by a trial balance such as that given above as exhibit 1. It is submitted that if their accounting practice were brought to a higher plane and the practice adopted of publishing periodical balance-sheets similar to exhibit 4, the results would tend to higher business ethics generally and the brokers themselves would not be without benefit through establishing greater confidence on the part of others.

Accounting for a Printing and Bookbinding Business

By AUSTIN L. BEAUJON

At the outset attention is called to the fact that the four major operations that comprise the manufacture of a book are four distinct kinds of business. Composition (or typesetting), foundry (or platemaking), printing and binding are most frequently performed in separate establishments, and each trade operates under its own particular labor union. When the four trades are combined in one organization under one management a complete plant is established for the manufacture of books from the manuscript to the bound copy, and the business enterprise could then properly be called book manufacturing. The name, however, has as yet not been adopted, and a business of this kind contents itself with the composite name of "printers and bookbinders," omitting the other two component parts, very likely because a string of the four names, "compositors, electrotypers, printers and bookbinders" would be rather cumbersome.

The printer and bookbinder does not market the books manufactured by him. That is done by the publishers who own the copyrights to the books but, with few exceptions, do not operate book-manufacturing plants because it not only requires a large outlay of capital to instal such a plant, but also because to be at all efficient the plant would have to be of a capacity far in excess of the requirements of the average book publisher. The printer and bookbinder, however, maintains a plant of sufficient capacity to meet the requirements of a number of publishing houses, and as he has no books of his own to sell he is not a competitor of the publisher but rather the manufacturing department of several publishing houses, his customers.

It may not be amiss to give a brief outline of the ordinary procedure of making a book as it will no doubt be helpful to a better understanding of the accounting system outlined later.

It should be clearly understood that all rights in and to the book are vested at all times in the publisher and not in the printer. The publisher makes whatever arrangements are necessary with the author and attends to all the editorial and art work, etc., and

prepares the manuscript for publication. When the manuscript is complete and the form and the style of the book have been decided, the manufacturing can be undertaken, and the publisher begins by obtaining estimates for the work, which are asked for and given separately for each of the four subdivisions mentioned above. Of course the publisher receives estimates from concerns that perform single operations only as well as from those that can quote on all the four operations. The latter have certain advantages, but nevertheless they must meet the competition of the single-operation plants, and this makes it essential, even if there were no other reasons, for a business of this kind to have a proper accounting system by departments.

Orders are placed by the publisher for the typesetting (composition), the plates (foundry work), for the printing of a certain number of sheets and the binding of a certain quantity of volumes, which need not be and usually is not for the full amount of the sheets printed. The manufacturing begins with the composition, which is practically all machine work. When the book is set, proofs on long sheets of paper, called galley proofs, are taken off the type and read for the detection of errors. Errors found are corrected, after which other galley proofs are taken and submitted to the publisher and author. Frequently changes and corrections are made by the author, but when the proofs are finally approved the type is made up into pages and locked into forms. Proofs are again taken and are reviewed and once more submitted to the publisher and the author. When these are found correct the forms are sent to the foundry for the next operation, that of electrotyping or platemaking, and the page proofs are sent to the billing department to be used in preparing the bill, which can now be rendered for the composition. The trade custom of treating each of the four operations as a separate transaction gives the printer and bookbinder the right to bill and collect for each operation as it is performed.

In the foundry electrotypes or plates are made of the pages—one plate for each page—and plate proofs are taken and submitted for approval as before. When these proofs are approved the plates are packed in heavy wooden boxes and the foundry operation is complete and can be billed to the customer. The type slugs are returned to the composing room where they are melted and cast into pigs to be used again, and the plates are

forwarded to the press-room for the third operation, that of printing.

Books are printed on flat sheets, each sheet usually forming 16 or 32 pages of the ordinary book. The paper on which the book is printed is nearly always furnished by the publisher to the printer, who, however, provides the ink. When the printing is to be done the plates are so arranged that the printed sheets when folded will have the pages in consecutive order. The forms are then adjusted on the presses and the edition is run off, and when completed the printing is billed to the publisher and the printed sheets are forwarded to the bindery. The plates are held subject to the publisher's orders.

To this stage no special difficulties arise for the accounting department. The business has performed labor under contracts and has rendered its bills immediately upon completion of each performance. The product of its labor becomes at once the property of the publisher and its inventory consists only of such work as may be in progress and an almost negligible quantity of supplies, such as ink, oils, electrotyping supplies, etc., which are usually purchased as required to avoid deterioration.

The fourth and last operation, however, the binding, offers several problems to the accountant because of peculiar customs in the trade. One is that the publisher can leave his sheets and books with the binder for an indefinite length of time—in fact, some publishers seem to consider it quite proper to use a binder's establishment as a storage warehouse. Another custom is that the sheets turned over to the binder are usually accompanied by an order to bind only a portion of the edition and to deliver only a portion of what was ordered bound. This custom probably originated from the fact that the publisher wanted his books as speedily as possible to sell and, not wishing to wait until all the volumes were bound, would take delivery of small lots as they were completed. However, as it happens that all books have not as ready sale as the publisher expects, he not only frequently delays giving the additional delivery orders for the balance of the edition bound, but also fails to provide for the unbound sheets. Unlike the other operations which are billed upon completion, the binding is usually billed upon delivery of such lots as the publisher calls for and the billing is consequently retarded if the publisher fails to call for his books or takes only a portion at a time. This

custom may perhaps be attributed to the dislike of the old-time binder to keep records of property that did not belong to him, as he no doubt considered that if the books were billed as delivered and deliveries were made in instalments occurring within reasonable periods, there was no necessity for intricate and voluminous records. The necessity for such records is now, however, fully realized, as notwithstanding the binder's endeavors to change the custom he has succeeded only in modifying it to some extent and in some cases. He finds himself at each inventory period with thousands of volumes on his shelves that do not belong to him and on which he has only a lien for his labor and profit, while the publisher's rights in them are sedulously guarded by the copyright laws. Of late, however, some binders have tried the plan of billing all books not ordered delivered within six months, and charging storage thereafter. Naturally this has not been joyfully hailed by every publisher, but it is fair to state that sooner or later every reputable publishing house takes its books off the hands of the binder, and in the case of a bankrupt publisher the binder is of course entitled to put in his claim for all the books ordered bound and held by him. He cannot, however, sell any of the books to satisfy a claim against the publisher unless he first obtains a judgment and levies on the books in his possession and buys them in at a sheriff's sale.

The inventory of the bindery consists of supplies such as cloth, leather, boards, glue, etc., usually in comparatively small quantities. In addition there are the books which are completed but have not yet been billed and the regular work in process. These books cannot be valued in the inventory at their cost as books, because all the operations prior to binding have either been paid for by the publisher or have been charged to his account. The inventory value of these books to the binder is, of course, the binding only, although as books they may be worth a great deal more. As in all cases of labor performed upon the property of another, the identical books appear on the inventories of both the publisher and the binder, the former taking them as sheets at their cost to him up to that point, while the latter takes them at the cost of binding. The two combined should be the cost of the book, minus the binder's profit. Indeed, one binder, to the writer's knowledge, inventories the books at his full claim on them, maintaining that they represent temporarily deferred

accounts receivable and are as good for full value as any of the other accounts already on his ledgers. The writer must admit that he agrees with this contention, but does not consider it necessary to give the matter more than a passing reference here.

The writer has thus far used the term "operations" to indicate the four major processes through which a book passes in the course of its manufacture; but in discussing the accounting system of the business the term "department" will hereafter be used to indicate the four stages. As a matter of fact the work in each department consists of numerous operations, there being probably as many as fifty altogether to produce a book from manuscript to bound volume. One-half or more of this number is performed in the binding department, where some of the principal operations are folding, gathering, sewing, backing and rounding, smashing, cutting, edging, case-making, stamping and casing-in. Truly, if it takes nine tailors to make a man, as the old saying goes, it takes fully one hundred people to make a book.

DEPARTMENTS

A complete printing and bookbinding establishment is divided into four departments representing the four major operations outlined above. These departments are called:

Composing room
Foundry
Press-room
Bindery

Sometimes sub-departments are created, as, for instance, the composing room may be divided into linotype and monotype departments; or the bindery may be separated into cloth bindery and pamphlet bindery; but whatever divisions are made the four distinctive lines are always kept separate. This is essential in the business, and the accounting system consequently must provide for following it on the books of account. The separation of these four departments should be as complete as if they were four independent business undertakings, which in a manner they are, although united under one management and complementary to each other. To obtain this complete segregation some owners of printing and bookbinding establishments operate the departments as two or more separate corporations. In the writer's opinion this is not necessary, as a proper system of departmental account-

ing gives quite as accurate results besides avoiding troublesome intercompany accounts and the bother involved in the management of a multiplicity of corporate units.

BOOKS OF ACCOUNT

The books used in a business with which the writer is familiar are general ledger, departmental ledgers, customers' ledger, cash-book, journal, sales and purchase records (the latter a voucher register with details of accounts payable), petty-cash book, notes receivable and payable registers and payroll records. Cost records are auxiliary to the general books.

General Ledger. The general ledger contains the regular balance-sheet accounts as well as the income and expense accounts of the business as a whole.

Departmental Ledgers. Each department has a separate ledger containing the income and expense accounts of the individual department. As the postings to these ledgers are made from distributive columns in the books of original entry from which totals are posted to the general ledger, the latter acts as a control on the accuracy of the departmental ledgers.

Sales Records. It has been found convenient to have two sales records, one for the bindery and another for the other departments. In the office parlance these are called "bindery sales" and "manufacturing sales," respectively. The manufacturing sales records are on loose leaves on which carbon copies of several invoices can be made. Columns are provided for the invoice amount and for each department and after the invoices have been entered on the sheets the amounts are extended into the proper department columns. There is no difficulty in determining the departmental distribution as the charges from each department even when combined in one invoice to the customer are always specified separately on the face of the invoice. The totals of the columns over a period will give, of course, the entire sales for that period as well as the sales by departments.

The entries on the sales record are carbon copies of the invoices rendered to the customers, copied from charge sheets prepared by the billing office from the workmen's time-sheets which are sent in daily by all departments. These time-sheets are tabulated on job-cost sheets. When a job is reported finished the job-cost sheet is completed, and in a section of the sheet provided for the

purpose the details of the invoice to be rendered to the customer are compiled by the billing clerk. This employee must be thoroughly familiar with the printing business, because a printer's bill can be rather a complicated affair as some of my readers may have occasion to know. The charge sheets as well as the orders received from the customers are numbered and a register is kept of them in numerical order. When an item is billed it is marked off on the register, the open items of which indicate the unfilled orders on hand and also serve as a check on the possible failure to bill a completed job.

For the bindery sales the method employed is different and the cost sheets are not used in billing as for the other departments. Since the billing here must be done on the basis of delivery, the customer's delivery order is used as the billing control. The delivery order is typed on suitable forms in quadruplicate, of which the original is retained in the office and three copies are sent to the shipping clerk. Of these, the first serves as the record of shipment, the second is returned to the office when the shipment has been made, and the third is sent with the books to be receipted by the customer. The second copy when returned to the office with all necessary information as to exact quantities delivered, routing, etc., is priced and extended together with the original that was retained at the office. This copy becomes the sales record, while the original is used as the customer's invoice. By numbering these sheets and providing for "back ordering" short deliveries, this system has been found to be an effective check on all goods leaving the premises, as the control is always with the office through the retention of the original sheet of each set of forms.

Purchase Record. The purchase record is of the usual standard columnar form. Distribution is by departments, but, in distributing by departments, the only information obtained from the record is the total of materials, supplies, etc., purchased for each department. It is also very desirable to know the principal items of which these totals consist. The system of classifying by number is therefore used. By it each class of material, supplies and expense is indicated by a number which is placed in front of the amount in the departmental column. The entries in the columns are tabulated according to these numbers on specially ruled sheets, each department of course being kept separate. In

this manner the desired information is always available in great detail without clogging the ledgers with numerous accounts and necessitating a purchase record with an unusually large number of columns.

Purchase invoices come to the accounting office from the purchase desk where they are checked and otherwise verified. No purchase can be made except upon requisition signed by the heads of departments and approved by competent authority. Every requisition is numbered and every purchase invoice must bear its corresponding requisition number.

Payrolls. Payrolls as a matter of course are made up by departments. The preparation of the payroll and the checks on its correctness are much the same as in any other manufacturing concern.

Other Books and Records. The other books and records used in the system hardly require explanation as they are all of standard form and use. In addition to the regular books of account, however, a great many stock records are kept, especially for the printed sheets, the paper stock and the bound books on the premises, all of which belong to the customers, as already explained elsewhere. These records are kept on cards and in a large establishment are very numerous, as a separate card is required for each book title. Great care must be used in keeping these records because on account of their volume it would be an exceedingly arduous task to have to check them all at one time. Portions should be checked from time to time, however, to verify the general accuracy and especially to determine whether proper care and diligence is being exercised.

DISTRIBUTION OF OVERHEAD AND MANAGEMENT EXPENSES

Wherever a charge can definitely be allocated to a department it is charged direct to that department. Rent, for instance, is charged to the departments on the basis of floor space used; electric power is charged as ascertained by separate meters installed in the departments; and depreciation is taken on actual departmental plant values. But the office and administration expenses, the selling expenses and some other expenses incurred for the business as a whole cannot definitely be allocated and must be distributed on some equitable basis. This distribution, it should be noted, is not a distribution of overhead expenses to depart-

mental costs but a charge of the proper proportion of these expenses to each of the separate units of a combination and is theoretically the equivalent of similar expenses that each department would incur if operated independently. To maintain the idea that the business as a whole is the consolidation of four distinct units these expenses must be prorated to the units at fixed and constant rates not subject to the temporary fluctuations of departmental activities. The proper rates can best be determined by a fair consideration of the relative worth of each department to the whole, taking into account the estimated proportionate amount of supervision, management and office work normally required for each of the departments. This of course is an estimate and obviously such an estimate will vary in different establishments. The main point in the writer's opinion, however, is not the rates themselves, but the fact that they should be constant. Any reasonable and fair estimate will serve the purpose, but, once determined, the rates should not vary until a radical permanent change in the business makes a revision desirable.

INTERDEPARTMENTAL PROFITS

It may be considered that the system outlined above is that of a concern with four distinct stages in manufacturing and that consequently under the method employed the business takes book profits instead of true profits at the completion of each stage. But that is not the case. If the writer has succeeded in making himself clear at the beginning it will be understood that as each stage in the manufacturing is completed it is charged, not to the next stage, but to the customer, whose property it becomes and from whom the printer expects and can demand payment of his bill. An author, if he pays his publisher for the manufacture of his book, may settle at the completion of the entire job or he may even be called upon to pay in advance, but the publisher in dealing with the printer and binder rarely transacts business except on the basis of the distinct operations outlined above. Instead of being a concern with four distinct stages of manufacturing, the combined printing and bookbinding business is a combination of four distinct but closely allied trades.

Economics and the Accountant

By EUSTACE LE MASTER

To the average man it may seem to be a far cry from the theories of Mills and Taussig to the theories he holds concerning the duties of the accountant. Even the average business man may see only the remotest connection between "the science of wealth and its relation to human welfare" and the man who compiles his yearly financial statement. But the experienced accountant is in constant contact with the phenomena of business. He deals daily with the terms and results of utility, value, prices, money, credit, wages, rents, interest, profits and so on. To him, a knowledge of economics occupies a position of prime importance in his equipment.

The accounting profession owes its existence to the greatest economic revolution in the recorded history of man. The almost total abolition of the domestic system and the tremendous growth of the industrial system of production in the white world have made our people a race of specialists. Modern inventions and the resultant increase in the capital goods of the world, the concentration of capital, the increase of production, the formation of huge credit machinery, the creation of hordes of dependent wage-earners and other factors have given rise to many problems of determining the rewards due the various classes of producers and distributors. Competition, which had heretofore been either a beneficial stimulant to individual effort or the death struggle between individuals, brought the menace of great suffering to many in the failure of enterprises. Cost statistics became a necessity. The specialist who compiled the systems for the collection of masses of recorded figures and miscellaneous data on production and reduced voluminous detail to statements of fact came into being. He is the cost accountant. The specialist who supervised the complex system of recording the figures and kept the accounting machinery in running order became the executive accountant. The growth of credit facilities, the creation of industrial banks, armies of bondholders and stockholders have created a need for the public accountant. He is needed by the executive who desires accurate data to answer the questions: Am I making money? How? Where? How much? The accountant is a prime factor

in the conservation of wealth and the prevention of waste. His very existence is inseparably connected with the most complex economic organization of the ages. A knowledge of the economic history of this era and a knowledge of the laws that produce its phenomena should induce in him the appreciation of his importance and the faith in his own usefulness to society to inspire him and spur him on to higher ideals and greater achievements.

The accountant without the knowledge of economic theory is comparable to the chauffeur without a working knowledge of gas engines and automobile construction. The chauffeur may be a capable driver. All may go well until some unusual occurrence disturbs the smooth-running machine. The chauffeur's ignorance may be the cause of the employer's weary tramp to other means of transportation. So the accountant may compile data from a smoothly running accounting machine until one of the many disturbing phenomena of our era interrupts the smooth course of business. A strike, a deflation of credit, a new competitor, over-production, a new invention, a flurry in prices, a war—these or many more may wreck a business and compel the executive to seek new fields of endeavor. The accountant's lack of knowledge concerning these economic manifestations, their precursors and reactions may mean failure and ruin to those dependent upon him.

The routine and elementary duties of the junior and semi-senior are constantly affected by economic theory. The analysis of accounts and the classification of income, costs and expenses are determined by the application of tests and rules derived from the knowledge of the rewards of capital, labor and enterprise. Even such an elementary task as the classification of items composing manufacturing and trading statements is simplified by and based on the theories of economics. The accepted practice of treating cash discounts on purchases as income from capital rather than as a reduction of costs is based on reasoning fostered by the study of economic theory. In fine, a knowledge of economics is a fundamental factor in accounting education and is necessary even in its most elementary stages.

The accountant's report is the real measure of his ability. Nor is the report to be judged good or bad by the number of its schedules of figures and percentages, by its fancy covers or by the imposing degrees following the signature on the certificate.

Voluminous remarks are not always necessary. A brief paragraph setting forth facts showing that the law of diminishing returns is already in force may be far more effective in certain instances and may save an executive clamoring for capital from disaster. A change in the expression of a certified balance-sheet may reveal the working of an economic law in a business and prevent a banker from sending good money after bad. Well reasoned comments on facts gleaned from masses of figures are worth far more to the executive than the figures themselves. How is the accountant to comment intelligently on his work, if he does not know the economic laws governing business? How is he to know for what facts and conditions to look in his examination of records, if he does not know the economic causes producing certain known conditions? How is he to know the relative value of the various sets of statistics he has compiled? The accountant's work must not only be the result of a careful application of the technical knowledge of his profession, but it must also be the result of a careful application of knowledge gained from a thorough study of the natural laws governing our complex business world. Important facts derived from figures, not schedules of figures, should be the meat of his report. Comments on causes, not a recitation of known effects, should be his report.

Recently the eastern creditor of a western dealer came hurrying west. A large account was considerably past due and the dealer was calling for more credit. The claim for additional credit was based on figures showing a steady increase in the volume of sales in a period of depression. The conclusion was that increased capital would insure success and future prosperity. After a conference, the dealer and the creditor went to a firm of reputable attorneys. Amended articles of incorporation were framed and provision was made for the flotation of preferred stock. Times were hard and investors cautious. The creditor conceived the idea of getting a certified balance-sheet to gain the confidence of prospective investors. In due time the balance-sheet was rendered. It revealed a condition of weakness bordering on insolvency. Appreciated fixed assets had been cut down to cost and depreciation reserves set up. Inventories were shown to be over 90 per cent. of total current assets. Current liabilities were shown to be in excess of current assets.

The accountant invited the creditor and the dealer to his office to discuss the situation. He told them that additional capital was not the solution of the problem, but that on the contrary increased capital without a change of policy would mean a greater loss. The creditor was interested but the dealer was inclined to be indignant at such presumption on the part of a "figure-maker." The accountant then laid before the dealer a statement of sales and margins for the preceding three years together with an analysis of selling and administrative expenses. Sales showed an average increase of 25 per cent. a year. The margin percentage had declined from 25 per cent. to 20 per cent. of sales. Selling expense percentages had remained constant, but administrative expense percentages had risen from 10 per cent. of sales to 17 per cent.

The dealer was selling semi-luxuries in a field of limited competition. Being a salesman, he had one idea: that increased volume of business meant increased profits. He was not acquainted with the fact that in his business price governed demand. Nor was he acquainted with the fact that the factors that governed profits were percentage of margin, volume of sales and cost of selling and administration. In his business, the greatest volume of profit was to be had by fixing the volume of sales by the margin percentage at the point where the volume of margins was greatest and the percentage of cost of selling and administration was the least.

The accountant recommended that the dealer raise his prices so that the margins would be 25 per cent. on staple competitive articles, 30 per cent. on semi-luxuries and 35 per cent. or more on luxuries. He also told the dealer what cuts would be necessary in his office force in the near future.

The creditor was converted but it required pressure to convince the dealer. Within three months the dealer's losses changed to profits and in six months a normal profit of 8 per cent. of sales was the yield of the business. The prediction of the accountant had come true.

The accountant's responsibilities do not cease with the performance of his professional duties. Like every other professional man, he is responsible to the community for his station in life, his education and the application of his specialized knowledge to public affairs. The accountant is particularly well fitted

to render service to the community by his close and intimate association with many businesses. If he is not well grounded in the theory of economics he is likely to prove a menace rather than a help.

Loose thinking in economics is responsible for much of the popular discontent of our day. The year 1920 witnessed a nation-wide campaign against so-called profiteers. Government checkers, pseudo-accountants, combed the books of large and prosperous retailers for sensational data. Reputable concerns were haled before grand juries and the data secured by the government agents were placed before them. Indictments were issued and some of the concerns were tried—and acquitted. Cases were dismissed wholesale. But irreparable injury to the reputations and businesses of respectable and law-abiding concerns was done by the activities of ignorant and irresponsible government officers. Had the government accountants known the principles of economics, the masses of figures turned out by them would never have reached the grand juries. They would have been able to get convincing evidence against the true profiteer and would never have attacked the men who were not taking advantage of an economic phenomenon to gouge the public.

In many cities, broad-minded and educated accountants made their influence felt by intelligent criticism of the governmental policies. In some cities, civic bodies gave them the privilege of their platforms. Much was done by the accountant trained in economic theory to restore confidence in the popularly discredited retailer.

In the year 1912 the Pacific northwestern pine belt witnessed the failure of many lumber manufacturers and a general depression of the lumber industry, due in a large measure to unintelligent competition. The pine manufacturers then combined in an association for the exchange of cost data and production records. Intelligent competition restored the industry to normal conditions. The small manufacturer enjoyed prosperity until the recent general depression. And yet this same association was attacked recently by an important government commission.

It is for the accountant with his assembled figures and his sound economic reasoning to help protect our industries from the attacks of probably conscientious but mistaken officers of government bureaus and commissions. It is also his duty to aid the

government by the same means to discover unfair methods of competition, profiteering, monopolistic combinations and kindred evils. This he can do only by being thoroughly familiar with the laws governing the phenomena of business.

A knowledge of business economics is essential to the successful performance of nearly every accounting task from the most elementary to the most complex. The great schools of the country, notably the universities of California and of Pennsylvania, have recognized this fact. Economics is a subject each student of accounting must study. The man who is dependent upon the correspondence school for his education should not confine himself to technical subjects, but should supplement his work with a thorough study of economics. He should be so familiar with its principles that he is able to read the financial page of the morning paper with as much interest and understanding as he reads the sporting page. It is only by the combination of the technical knowledge of his profession and a knowledge of economics that he can render his greatest service to industry and the nation.

Special Phases of Lumber Accounting

By RICHARD S. WYLER

The lumber industry is engaged in the exploitation of natural resources and embraces some accounting features not generally found in other lines of manufacture nor in commercial accounting. A discussion of the accounting problems peculiar to this industry may therefore be of interest and is presented under the following captions :

Depletion
Depreciation
Inventories

DEPLETION

Lumber manufacturers are engaged in converting a raw material known as timber into a finished product known as lumber. As the raw material or timber was acquired for a consideration and has a value, provision must be made for the return to the owners of the capital so invested upon the exhaustion of the holdings. This is accomplished by means of a depreciation or depletion charge to operations for the timber cut and manufactured and an offsetting credit to the timber account to denote the reduction in the available supply on hand. It is essential, therefore, that a proper basis be fixed for the depletion of the holdings for the purpose of

- (a) The amortization of the timber investment during the life of the holdings;
- (b) The equitable absorption of the amortization charge in the production accounts, in order correctly to ascertain the cost of the product manufactured.

The first prerequisite for a proper depletion charge is the determination of the cost of the timber. The latter is generally acquired in large tracts, including in most cases the land on which it grows. In order to determine the initial cost of the stumpage, it is necessary to segregate the cost of the land from the cost of the timber. As the area of the land is usually known and as a value can be placed thereon, no difficulty is encountered in allocating the purchase price to the two elements.

As a timber supply sufficient to permit its operation for a number of years must be acquired in order to justify the con-

struction of a manufacturing plant, it is evident that interest, taxes and other carrying charges will accrue before the timber is exhausted. The question arises, therefore, as to the treatment of these charges as capital outlays or current operating expenses. In cases where the holdings are large and will not be exhausted for ten or more years, an undue burden would be placed upon current operating costs if all of the carrying charges were absorbed. In these cases, the manufacturer is justified in capitalizing them. Due to the fact that there is a constantly diminishing supply of timber, its value has uniformly increased over periods of years, despite temporary declines in times of depression. If carrying charges are capitalized, the depletion charge will more clearly reflect the actual value of the timber when it is cut. Consideration should be given to the fact that if the operator should defer the acquisition of this excess supply until it was required for manufacturing purposes, a higher price would have to be paid under normal conditions than that expended for the initial supply. The operations of future years may therefore properly be charged for the carrying of the timber and the risks thereby involved. The practice of absorbing the carrying charges direct in the operating accounts is of course more conservative, and operators holding a limited supply of timber only gain nothing by capitalizing them. This refers only to plants which are in operation. Corporations which are not operative and have no income but hold timber for future use should capitalize these charges. The federal income-tax regulations provide that after properties are on a normal production basis, such expenditures shall be treated as current operating expenses. During the high tax period from 1917 to 1921, inclusive, lumber manufacturers generally absorbed the carrying charges in their operating costs.

After finding the cost of the timber as above explained, a basis is furnished for the determination of the depletion charge to operations for the timber cut. In the past many lumber manufacturers have used an arbitrary rate for depletion, which was not based directly upon the cost of the timber. In well managed and prosperous mills, the depletion unit used was high and was generally based on the market value of the finished product, so that the investment account, at the completion of the particular operation, would show a considerable profit. In mills less pros-

perous, the reverse was true and the depletion rate was frequently below the actual unit cost of the stumpage, so that the timber account would show a loss when the supply was exhausted. Neither basis is correct, as the depletion unit should be based upon the cost of the timber, irrespective of market fluctuations in the finished product. The cost furnishes a stable basis, while depletion charges based on the market value of the lumber fluctuate constantly and do not permit a useful comparison of operating costs over a period of years. While lumber prices are governed by the law of demand and supply and by special conditions prevailing in the industry, timber values are not subject to such frequent and radical variations. The latter are governed by the quality of the timber, the density of the stand, its accessibility and its location in respect to the consuming markets. Stumpage of good quality will produce a larger percentage of the higher grades of lumber, and the realization from the manufactured product will therefore be greater than in the case of low-grade timber. If the stand is heavy and if the timber is easily accessible, less development work is necessary and logging costs are lower. If it is well situated, close to railroad facilities and the consuming markets, the transportation cost of the finished product is lower and, conversely, the net realization to the manufacturer is greater. While constant rises of lumber prices over a period of years will affect the value of the raw material, it is also true that seasonable market fluctuations do not react upon the value of the timber and should not be taken into consideration in establishing depletion charges to operations.

The cost of the timber being established, the unit depletion rate is determined by dividing the cost by the estimated cut. Estimates of the available supply are generally prepared by professional timber cruisers and are more or less trustworthy. Before accepting these estimates, however, tests should be made with the actual cut from specific tracts, or the average stand per acre as shown by the estimates should be compared with the actual cutting experience. Overestimates thus disclosed should be adjusted. The average depletion unit will change from year to year, as new purchases should be taken into consideration in determining the unit.

The depletion unit as above determined is applied against the timber cut during the year and furnishes the depletion charge to

Special Phases of Lumber Accounting

operations and conversely the credit to the timber or the depletion reserve account. When log inventories fluctuate in quantity, it is desirable to base the depletion charge on the timber actually cut in the woods. In this case an inventory of the logs on hand must be taken and reflected in the operating accounts. In case the cut is a hand-to-mouth matter and the quantity of logs on hand is small and constant, the depletion charge may be based upon the quantity of logs manufactured at the mill. The following example discloses the operation of the timber and land accounts:

Timber and land purchased:

Land	Acres	30,000
Timber—estimate	M feet	150,000
Purchase price		\$660,000.00
Average value of land—per acre		2.00
Average value of timber—per M feet ...		4.00

TIMBER AND LAND ACCOUNT

	Total	Timber			Land		
		M feet	Average per M feet	Amount	Acres	Average per acre	Amount
Initial purchase	\$660,000.00	150,000	\$4.00	\$600,000.00	30,000	\$2.00	\$60,000.00
Timber cut during year		20,000	4.00	80,000.00			
Land sold	80,400.00		4.00		200	2.00	400.00
Balance at end of yr.	579,600.00	130,000	4.00	520,000.00	29,800	2.00	59,600.00
New purchases	107,500.00	20,000	5.125	102,500.00	2,500	2.00	5,000.00
	687,100.00	150,000	4.15	622,500.00	32,300	2.00	64,600.00
Timber cut	103,750.00	25,000	4.15	103,750.00	.....	....	.....
Balance at end of yr.	583,350.00	125,000	4.15	518,750.00	32,300	2.00	64,600.00

When the timber stand comprises several species, these may be segregated into separate accounts at varying unit values, and the depletion charge may be separately calculated on the basis of the quantities of the several species cut. If desirable, the timber area may be divided into several blocks according to its location, or new purchases may be carried as separate units and several timber accounts may be operated with varying depletion rates. When new purchases are intermingled with the old tracts, it is desirable to use the above average cost basis at the end of each year for the purpose of determining the unit depletion rate.

The several federal income-tax acts provide for the revaluation of timber acquired prior to March 1, 1913, on the basis of

the fair market value at that date, which has complicated the treatment of timber accounts. Many manufacturers who revalued their timber have credited the resulting appreciation to the regular surplus account. This, of course, was incorrect, as the credit represented simply a book appreciation. The proper procedure requires that this surplus be credited to a special account, and that the amount realized each year only be transferred to the earned surplus account as non-taxable income. As new purchases made after March 1, 1913, and cut in subsequent years are generally intermingled with timber bought prior to that date, it is as a rule impossible to allocate the timber cut to the specific tracts. The amount of appreciation realized each year applies only to the timber cut from purchases prior to March 1, 1913. The yearly cut must therefore be allocated to the two classes on the basis of the ratio of the purchases prior to March 1, 1913, to the total holdings at the end of each year, as shown in the following table:

	Total		Purchases before March 1, 1913—		Purchases after March 1, 1913	
	M feet	Amount	M feet	Total	Cost	Appreciation
Balance at beginning of year	100,000	\$540,000	60,000	\$300,000	\$180,000	\$120,000
Average per M feet		5.40		5	3	2
Ratio of purchases prior to and after March 1, 1913, to total holdings						
	%	100	60		40	
Timber cut during year	20,000		12,000		8,000	
Depletion charge		108,000		60,000	36,000	
Appreciation realized					24,000	48,000
Balance at end of year	<u>80,000</u>	<u>\$432,000</u>	<u>48,000</u>	<u>\$240,000</u>	<u>\$144,000</u>	<u>\$96,000</u>
					<u>\$2,000</u>	<u>\$192,000</u>

The land account may be operated on approximately the same basis as the timber account. As the date of acquisition of each tract is usually known, sales of land can be allocated to tracts acquired prior or subsequent to March 1, 1913, and realization of appreciation will only be claimed for acreage sold from purchases prior to that date.

DEPRECIATION

Depreciation of lumber plants is governed principally by the factor of obsolescence through the exhaustion of the available timber supply, rather than by the decline in value resulting from wear and tear. In view of the fact that mills are generally adjacent to or in the timber holdings, their value depends upon their usefulness to the present owners. They are reduced to a salvage value whenever the timber is cut out, irrespective of the physical condition of the machinery at that time. Regular depre-

ciation rates applied on mill machinery, buildings, etc., may result in a depreciated value reflecting the actual physical condition of the property as a manufacturing operation, which, from the standpoint of future usefulness, may be entirely out of proportion. By using for depreciation purposes a rate based upon the current exhaustion of stumpage, assurance is given that the plant investment will be reduced to the salvage value whenever operations are discontinued. The charge to operations, being governed by the yearly production, places a uniform burden upon the units of lumber produced. As the timber stand is known, no difficulty is encountered in the use of this method.

In determining the estimated timber stand for depreciation purposes, it is frequently desirable to include, in addition to the timber owned, a conservative estimate of adjacent timber, which the operator expects to secure. If practically all the available supply is held, this procedure is of course not necessary. If, however, the plant owns only a small initial supply of timber, but expects to acquire considerable additional stumpage, the depreciation charges during the early years of operation will be too high if only its own holdings are taken into consideration. The estimates are applied on the cost of the plant, after allowing for the estimated salvage value. The rate thus obtained represents the depreciation chargeable to each unit of production, which is usually based on a measure of one thousand feet. The rate is readjusted each year to absorb additions to plant and to reflect additional timber acquired.

As sawmill plants are generally complete at the commencement of operations, minor additions in subsequent years should be charged to current operating expenses, unless they materially increase the manufacturing facilities or the efficiency of the plant. In plants where the buildings and heavy machinery can be used until the timber stand is exhausted but more delicate machinery will have to be replaced during the course of operations, a special reserve for replacement should be provided in order to preclude an undue increase in depreciation charges in later years. The expected replacement cost may be reflected in the regular depreciation charges, an allowance being made therefor in determining the depreciable value of the plant.

Logging equipment, including log cars, loaders, etc., tractors and trucks, has a relatively short life. It is frequently replaced

during the life of the operation and should be depreciated on the basis of established depreciation rates governed by decline in value through wear and tear. Livestock, wagons, etc., are subject to hard usage and frequent losses in the course of operations. Stock is continually added or sold. The application of fixed depreciation rates is therefore unsatisfactory if one would state these assets at a representative value in the balance-sheet. While an allowance based on the estimated depreciation should be included in the monthly operating accounts, it is desirable to revalue these assets by means of conservative inventories at the end of each year and to adjust the annual depreciation charge on that basis.

INVENTORIES

The valuation of inventories in the lumber industry offers some difficulties not generally encountered in other manufacture.

The operating accounts reflect the average cost of the product without regard to grades. During the war period the market values of the products were generally higher than the cost, and inventories on the basis of average cost of production resulted, in fact, in a valuation based on cost or market, whichever was lower. The heavy declines in market prices during the past two years reduced the sales value of the product of many grades below cost and the average cost of production does not offer a satisfactory inventory basis. The selling price of lumber is quoted by grades and it is necessary either to reduce the several market quotations to an average market price, which can be compared with the average cost of production, or to determine on the basis of the average cost of production the cost applicable to the several grades. This is accomplished by determining the quantities of the various grades produced during the year and applying these quantities on the market price less an allowance for selling, shipping and administration expenses, including therein a reasonable marketing profit. If the average thus obtained is lower than the average cost of production, it should be applied against the entire inventory, and, conversely, the average cost of production should be used if the average market value is higher. The inventory valuation is thus based on cost or market, whichever is lower.

This method should only be used, however, when the grades of lumber on hand are in the same proportion as the average grades of production. If the closing inventory includes an abnormal

percentage of low-grade lumber it will be overstated if valued on the above basis, and it will be understated if the percentage of low-grade lumber on hand is subnormal. Under such conditions the average market value of the product manufactured during the period should be determined by applying the production of the several grades on a normal or average market price. The ratios of the market prices of the various grades to the average market price should be calculated and these percentages should be applied against the average cost of production in order to find the cost of the lumber by grades. A comparison can then be made between the market prices of the various grades and their cost, the lower being used for inventory purposes. The market price is based on the finished product and, if applied on the inventory quantities of the lumber in the yard, no consideration is given to shrinkage and reduction in grade, which occurs when the lumber is dressed for shipment. In valuing the inventories, an allowance should therefore be made for cut-offs and reductions in grade.

The JOURNAL of ACCOUNTANCY

Official Organ of the AMERICAN INSTITUTE OF ACCOUNTANTS

A. P. RICHARDSON, *Editor*

EDITORIAL

Protecting the Certified Public Accountant

In a recent confidential bulletin sent to the members of the American Institute of Accountants, it was announced that a preliminary injunction had been issued against the National Association of Certified Public Accountants, the District of Columbia corporation whose issuance of certificates purporting to confer upon the holders the "degree" of certified public accountant has aroused qualified certified public accountants throughout the country.

The National Association of Certified Public Accountants duly filed answer to the government's bill of complaint. The district attorney filed a motion to strike out the answer on the ground of insufficient answer as a matter of law to the allegations of the bill of complaint. On July 18th the matter came up before Judge Hoehling who heard the argument of counsel and stated that the defendant's answer was insufficient and ordered it stricken out. The court indicated that the case appeared to be one in which a final injunction is appropriate and the court has now under consideration the question of technical procedure as to whether a final injunction is proper on the present state of the record or whether it should be deferred to a later stage of the proceedings.

The effect of the injunction is that the National Association of Certified Public Accountants, a corporation, its officers, directors, agents and servants are restrained and enjoined from soliciting applications from any persons for the issuance to such persons of any certificates, diplomas or other instruments of writing conferring upon such persons the degree or designation of certified public

accountant or any other degree or designation of similar purport. It enjoins and restrains the National Association of Certified Public Accountants from making known to the public or to any persons by any printed or written instrument or by any statement that the National Association of Certified Public Accountants is authorized under its certificate of incorporation to issue such certificates or other instruments of writing purporting to confer the degree or designation of certified public accountant or any other similar degree. It also restrains and enjoins the National Association of Certified Public Accountants from issuing any such certificate or other instrument of writing purporting to confer the degree of certified public accountant.

It is not believed that the defendant can make any answer that can be effective as a matter of law or more comprehensive than the one stricken out. It is not known whether the court will decide to sign the final injunction or not, but in any event the preliminary injunction holds good until the question of the final injunction is determined. It may be that the final order will be signed within a few days, or possibly some further steps of procedure may be found necessary before the court will consider a final determination appropriate, but it is believed that the case against the National Association of Certified Public Accountants is rapidly approaching a conclusion in the supreme court of the District of Columbia.

We have never been in any doubt as to the ultimate triumph of right in this as in other matters. It is gratifying to know that the evidence which has been accumulated during the past year by the American Institute of Accountants has been of such a nature as to convince the United States district attorney for the District of Columbia that a suit for injunction should be begun. Some of our readers have expressed the opinion that the Institute was dilatory in getting together the evidence which was required. Matters of this kind, however, must move slowly, particularly, as in this case, where competent evidence had to be secured from various parts of the United States. We do not believe that an appeal would avail the National Association anything, and, should an appeal be taken, we are confident that the appellate court would affirm the granting of this final injunction; so we are confident in the belief that the practices of the National Association, which

we deemed hostile to the standards supported by the American Institute of Accountants, will never be resumed.

The holding of the supreme court of the District of Columbia in this injunction case is therefore a victory which vindicates the high standards for which the American Institute, in common with all other good elements in the profession of accountancy generally throughout the country, has always stood. The unfortunate truth is that the public does not always differentiate between certified public accountants and as a rule pays little attention to the sources of their designations or certificates. But with the publicity attendant upon the injunction proceedings, it may not be too much to hope that the business public at least will take care in future to see that the certificates displayed by accountants have an official value.

Use of Designation "C. P. A."

There are wide differences of opinion as to C. P. A. legislation in the states and as to the extent to which restriction and reciprocity between states should be carried. In a recent issue of this magazine we published with brief comment a decision of a magistrate in the city of New York to the effect that practice as a certified public accountant in New York was legal only in the case of holders of New York certificates. The man from a neighboring state holding a certificate of that state and describing himself in New York as a certified public accountant of that neighboring state by this opinion would have been made guilty of a misdemeanor and subject to penalty. This subject is so controversial and so often discussed that it is unnecessary to comment upon it here. The arguments for and against have been written and rewritten times out of number. However, in view of the fact that the magistrate's decision was published in these pages, we feel it proper to publish the following decision of a judge of the court of special sessions of New York in the same case. The text of the decision which overrules the finding of the magistrate is as follows:

THE PEOPLE OF THE STATE OF NEW YORK,
against

ERNEST H. BROWN

The defendant was tried in this court on an information charging that he violated section 80 of the general business law of the state of New York in that he unlawfully did assume the title of certified public accountant and did use the abbreviation "C. P. A." to indicate that he, the said defendant, was such public accountant.

Section 80 of the business law provides that a citizen of the state of New York who has received from the board of regents of the university of the state a certificate of his qualifications to practise as a public expert accountant shall be styled and known as a certified public accountant and that no other person shall use such title or use the abbreviation "C. P. A."

The defendant inserted on July 15, 1921, an advertisement in a telephone directory, distributed in the city of New York, in which he styled himself E. H. Brown, C.P.A. (N. H.).

The people concede that the defendant was certified in the state of New Hampshire as a public accountant some time in the past, and was such accountant on the date of the filing of the information in this court. It is also conceded that the letters (N. H.) represent what is understood to mean the state of New Hampshire. Admission was made that he never received a certificate in the state of New York.

The district attorney contends that the defendant in advertising himself "C. P. A. (N. H.)" committed a misdemeanor violating section 80 of the business law, the provisions of which are set forth above. I cannot agree with him. In my opinion the defendant in so advertising himself did not do that which is prohibited by section 80 of the business law. In other words, in using the above letters, he did not hold himself out to the public as a certified public accountant of the state of New York.

Anyone may practise as a public expert accountant and advertise as such without license or permission. He may also set forth in such advertisement any qualifications which he thinks he possesses, so long as no deception is intended, to aid him in obtaining clients. Thus, if such person were a graduate of a university and had received the degree "bachelor of arts," he may, without violating any law, so inform the public by writing after his name the customary letters "A. B." The defendant was within his rights and within the law in informing the public that one of his qualifications for practising accountancy is the fact that he was certified as such by the proper authorities in the state of New Hampshire.

It cannot be contended that the statute arbitrarily forbids the use of the words certified public accountant or C. P. A. It only forbids such use when the result of use is intended to deceive. The law was obviously intended to safeguard the public against wrongful misrepresentation as to the qualifications of the practitioner. As to the point raised that the letters N. H. were not sufficiently descriptive and might suggest other meaning than New Hampshire, it seems to me the use of such letters is notice to the public to inquire and clear up any ambiguity which might exist.

For the reasons stated, I vote to acquit the defendant.

D. F. MURPHY,

Justice, court of special sessions.

Probably many of our readers will rejoice in the decision of Judge Murphy and will feel that the profession has been accorded the interstate character to which it is entitled. To mitigate the joy of such readers we must report that the same judge on the same day delivered a similar judgment in the case of one Doyle against whom action was brought for describing himself as "C. P. A. (N. A.)" which was the designation adopted by members of the National Association of Certified Public Accountants.

But the injunction granted in the District of Columbia probably effects nationally what the Doyle case was expected to accomplish only locally.

Hamilton S. Corwin

Another great loss has come to the accounting profession in America. Hamilton S. Corwin died at San Diego, California, July 17th, after a comparatively brief illness.

To those who had been privileged to have a personal acquaintance with Mr. Corwin the loss is peculiarly keen, but we doubt exceedingly if there is in the whole profession a man or woman who has not at one time or another known of some of the good work which was done for the profession by this splendid, clear-thinking exponent of the highest ethical ideals.

Mr. Corwin had been a member of the council of the American Institute of Accountants and was active on various committees. He served on the executive committee and various special committees dealing with important developments in the growth of the profession. He was also at one time president of the New York State Society of Certified Public Accountants. In all these activities he displayed an ability to think through and to decide wisely on all subjects which were brought to his attention. Those who were associated with him in committee work had acquired the habit of waiting for the final summing up of results of deliberations and the making of concrete suggestions by Mr. Corwin.

His loyalty to the aims and purposes of the American Institute of Accountants was such that at considerable cost of time and effort he was always ready to undertake duties imposed upon him by the Institute.

To the members of Mr. Corwin's family and to the members of the firm of Patterson, Teele & Dennis, of which he was for many years a partner, we extend our sincere sympathy.

Admission Requirements of American Institute

Our attention has been drawn to the fact that there is a possibility of misunderstanding a rule of the board of examiners of the American Institute of Accountants as it was reported on page 38 of the July issue of *THE JOURNAL OF ACCOUNTANCY*. Only one reader seems to have discovered the possibility of ambiguity, but in case other readers may have been confused it should be pointed out that the board of examiners in giving credit for other

examinations will classify the applicants according to their length of practice.

The accountant who has had only two years of public accounting experience will be considered for admission as associate. The applicant who has been five years continuously in public practice or has had a total of ten years' public practice, not necessarily continuous, will be considered for admission as member.

Income-tax Department

EDITED BY STEPHEN G. RUSK.

We offer for consideration of our readers' this month several decisions of more or less interest—more to those who have tax matters to handle for estates, and less to those who have no such matters. Three of the decisions published this month refer to estate taxes and one refers to the application to a particular case of section 209 of the revenue act of 1917. If the reader has a client who has not been finally allocated for the levying of 1917 excess-profits tax among those whose excess-profits tax should be computed at the rate of 8 per cent. over the allowable credits and exemptions' or among those paying the tax at the graduated rates, he will read with some interest treasury decision No. 3334.

(T. D. 3334—May 25, 1922)

Excess-profits tax—Revenue act of 1917—Decision of court.

INVESTED CAPITAL—SELLING AGENT—TAXABILITY UNDER SECTION 209.

Plaintiff corporation acted as sole agent for a mining company under an arrangement contemplating that it should discount drafts in the case of foreign shipments and pay the amount of the invoices in the case of domestic shipments, retaining in both cases only commissions and interest, so that the principal was constantly in the corporation's debt for advances. The corporation was incorporated for \$25,000, and in 1917 had capital, at the beginning of the year, of \$51,074, and income of \$26,890.34 from commissions from selling for account of its principal, \$22,133.25 profits from buying and selling on its own account, and \$5,851.90 from interest. In 1915 the proportion of gross profits from trading on its own account was 23 per cent.; in 1916, 9.8 per cent., and in 1917, 45 per cent. Its profits during 1917 were retained, and not distributed as dividends, and its officers made substantial advances to aid it in financing the business. The capital of the corporation was not used merely to pay ordinary expenses, but to assist in paying advances to its principal, as well as to trade on its own account. During 1917 its capital was engaged in its business and was being turned over in connection with sales, its advances including capital available or capital repaid from advances. On December 31, 1917, when its bank balance was larger than in any other month of the year, it was only \$16,501.67, while its capital and surplus amounted to \$78,330. *Held*, that such corporation did not merely buy and sell on commission but traded substantially on its own account, and had a substantial invested capital which was employed in making advances to or on account of its principal, and also in buying merchandise on its own account for profitable sale, and hence it was not entitled to assessment under section 209 of the revenue act of 1917, which applies only to businesses having no invested capital or not more than a nominal capital.

The appended decision of the United States district court for the southern district of New York, rendered March 10, 1922, in the case of *R. H. Martin (Inc.) v. William H. Edwards, collector*, is published for the information of internal revenue officers and others concerned.

NO. 751. UNITED STATES DISTRICT COURT, SOUTHERN DISTRICT OF
NEW YORK.

*R. H. Martin (Inc.), plaintiff, v. William H. Edwards, collector of internal
revenue, second district of New York, defendant.*

[March 10, 1922.]

AUGUSTUS N. HAND, judge: The plaintiff brings this suit to recover the sum of \$8,348.50, the amount of an excess-profits tax alleged to have been

erroneously assessed under the revenue act of 1917, and paid to the defendant under protest.

The plaintiff corporation acted as sole agent for the Martin Bennett Asbestos Mines, located at Thetford Mines, in the province of Quebec. Under a written agreement, dated June 14, 1913, made between the Martin Bennett Asbestos Mines and Robert H. Martin, it was provided that invoices and bills of lading for each shipment of ore made by the Martin Bennett Asbestos Mines to its customers were to be sent direct to R. H. Martin, who had no responsibility to effect collection. In the case of export shipments Martin was to remit the amount of his sale less commission and interest as soon as he had negotiated with his bankers the drafts against such shipments. In the case of domestic shipments he was to make settlement by sending his check less commission and interest as soon as the invoice could be properly checked up and accounted. The written memorandum stated that Martin did not guarantee any of the accounts, and in the event of their not being paid upon the date of maturity he was entitled to charge the whole amount with interest back to the Martin Bennett Asbestos Mines. The foregoing arrangement evidently contemplated that Martin should discount the drafts in the case of foreign shipments and pay the amount of the invoice in case of domestic shipments, retaining only his commissions and interest. The plaintiff was organized for the purpose of carrying on the agency business of Robert H. Martin and his son and residuary legatee, Alexander R. Martin. It was incorporated with a capital of \$25,000, and assumed the agreement of Robert H. Martin, heretofore mentioned, which he had made with the Martin Bennett Asbestos Mines. It paid Alexander R. Martin, as president of the company, a salary of \$5,000, which was concededly less than the value of his services to the company.

Plaintiff seeks to recover taxes alleged to have been overpaid upon the theory that taxes should have been computed pursuant to section 209 of the revenue act of 1917. This section provides:

That in the case of a trade or business having no invested capital or not more than a nominal capital there shall be levied, assessed, collected, and paid, in addition to the taxes under existing law and under this act, in lieu of the tax imposed by section two hundred and one, a tax equivalent to eight per centum of the net income of such trade or business in excess of the following deductions: In the case of a domestic corporation \$3,000; and in the case of a domestic partnership or a citizen or resident of the United States, \$6,000; in the case of all other trades or business, no deduction.

Article 73 of the regulations of the commissioner of internal revenue, approved October 3, 1917, provides that—

Agents and brokers requiring and using no capital or merely a nominal capital in their business are taxable under article 15 (same as section 209) but commission houses regularly employing a substantial amount of capital, whether to lend to principals or to carry goods on their own account, are not deemed to be agents or brokers. . . .

Article 74 provides that—

. . . . The term nominal capital as used in section 209 means in general a small or negligible capital whose use in a particular trade or business is incidental. The following will not construe as business having a nominal capital for purposes of excess-profits tax:

(a) A business which because of conditions arising from the war or exceptional opportunities for profits earns a disproportionately high rate of profits during the taxable year, if it belongs to a class which necessarily and customarily requires capital for its operations

(b) Corporations which although their capitalization is nominal employ a substantial amount of capital in their business.

During the year 1915 the plaintiff purchased on its own account merchandise to the amount of \$94,021.72 and sold such merchandise for \$98,626.31. In 1916 such purchases on its own account amounted to \$47,011.16 and sales on its account amounted to \$49,225.66. In 1917 such purchases on its own account amounted to \$27,156.55 and sales amounted to \$49,289.89.

The plaintiff's capital at the beginning of the year 1917 was \$51,074. The plaintiff was obliged under its arrangement to make settlements for domestic shipments by sending its check, less commissions and interest, as soon as the invoices could be properly checked up, and this it did.

During the year 1917 its income was derived from the following sources:

Commissions from selling for account of the mines.	\$26,890.34
Profits from buying and selling on its own account.	22,133.25
Interest	5,851.90
Total	\$54,875.49

If it had limited itself to buying and selling on commission, with a small incidental trading on its own account, the plaintiff's contention would be good, but in the case of this corporation it is evident that there was substantial trading on its own account and also that it required capital to conduct its business in the way it was conducted. In 1915 the proportion of the gross profits received by the plaintiff for trading on his own account was 23 per cent.; in 1916, 9.8 per cent.; and in 1917, 45 per cent. Its profits during the year 1917 were retained, and not distributed as dividends, and its officers continually made substantial advances besides to aid it in financing the business it conducted. The capital was not used merely to pay the ordinary expenses of the corporation, which were less than \$3,000 a month, but to assist in making advances to its principal, for whom it was acting as selling agent, as well as to trade on its own account.

I have indicated above that there was considerable trading by the plaintiff on its own account in 1915-16, so that the large amount of such trading in 1917 can not be regarded as merely "incidental." (See art. 74 of regulations.) It is urged that during the year 1917, outside of the months of January and February, when the remittances exceeded the receipts by \$6,088, plaintiff was able to conduct its business without resorting to its capital. This argument is based on the fact that except during those two months it seems to have received more than it paid out. Its capital was, however, during this very period engaged in its business and being turned over in connection with sales of asbestos. Its advances included capital available or capital repaid from advances. If this is not so, I can not see where its capital was or what use was being made of it. On December 31, 1917, when its bank balance was larger than in any other month of the year, it was only \$16,501.67, and yet the capital and surplus then appears by the balance-sheet to have amounted to \$78,330. In its balance-sheet of December 31, 1916, out of its assets of \$97,842.10, \$76,606.47 seems to have represented accounts and bills receivable derived from sales for the account of the mines and sales on its own account, \$13,872.50 seems to have represented loans as direct advances to the mines, before maturity of the bills of customers of the latter to whom plaintiff had sold products of the mines. The balance-sheet of December 31, 1917, indicates the same sort of situation. Approximately only \$16,000 of the capital and surplus, which aggregated \$78,330, was available in the form of cash in bank.

The situation somewhat resembles that in *Farmers Loan & Trust Co. v. Anderson* (241 Fed. 322.) There it was argued that the Farmers Loan & Trust Co. of New York was not subject to a tax upon capital and surplus employed in banking because there were sufficient investments to exhaust its capital. The trust company unsuccessfully attempted to attribute all its large and varied banking business to the use of assets other than its capital, because there were sufficient permanent investments

to exhaust the latter. Here it may be that there were sufficient bills and accounts receivable derived from sale of products of the mines to offset all loans and advances to the latter, but they had not been collected, and the capital of the plaintiff was needed, though temporarily, to make good the advances which were constantly made before the 60 days' credits to customers of the mines had expired and the money came in. Every successful business would have its capital not only unimpaired but unemployed if its outstanding accounts receivable could be at all times liquidated forthwith, but the chief use of capital is to carry it along until the payments come in.

I am of the opinion that the plaintiff had more than a nominal capital and had a substantial invested capital which was employed in making advances to or on account of the mines and also in buying merchandise on its own account for profitable sale.

A verdict is accordingly directed for the defendant.

(T. D. 3338—May 29, 1922)

Estate tax—Act of September 8, 1916—Decision of Supreme Court.

1. RETROACTIVE OPERATION OF STATUTE—TRUST INTENDED TO TAKE EFFECT AT OR AFTER DEATH.

Act of September 8, 1916, Title II, is prospective and not retroactive in operation, and section 202 (b) thereof is therefore not applicable to a trust created prior to the passage of the act, but intended to take effect in possession or enjoyment at or after the death of the creator of the trust who died subsequently to the passage of such act.

2. ACTIONS TO RECOVER TAX PAID—SUCCESSOR TO COLLECTOR AS PARTY DEFENDANT.

Suit may not be brought against a collector of internal revenue for the recovery of a tax, in the collection and disbursement of which such officer had no agency; therefore, the substitution of the successor to a collector who collected a tax as defendant on the resignation of such collector was error, and a defense of nonliability set up by such successor is sufficient. (*Smietanka v. Indiana Steel Co.*, T. D. 3304, followed.)

The appended decision of the supreme court of the United States, dated May 1, 1922, in the case of *Union Trust Co. et al., executors, v. Wardell, collector*, reversing the judgment of the district court of the United States for the northern district of California (T. D. 3151), is published for the information of internal revenue officers and others concerned.

SUPREME COURT OF THE UNITED STATES. No. 236. OCTOBER TERM, 1921.

Union Trust Co. of San Francisco and Albert Lachman, as executors of the last will and testament of Henriette S. Lachman, deceased, plaintiffs in error, v. Justus S. Wardell, United States collector of internal revenue for the first district of California, and John L. Flynn, United States collector of internal revenue for the first district of California.

ERROR to the district court of the United States for the northern district of California.

[May 1, 1922.]

Mr. Justice McKENNA delivered the opinion of the court:

This case was argued at the same time and submitted with No. 200, *Schwab v. Doyle*, just decided. It involves, as that case did, the estate tax act of September 8, 1916, and its different facts illustrate and aid the principle upon which that case was decided.

Plaintiffs in error are executors of the last will and testament of Henriette S. Lachman, deceased. They were also parties to a trust deed made by her during her lifetime. They sued defendant in error Wardell, he then being United States collector of internal revenue for the first district of California, to recover the sum of \$4,545.50 that

being the amount of a tax assessed against the estate of Henriette S. Lachman, upon the value of 4,985 shares of stock transferred in trust by Henriette S. Lachman to trustees upon the assumption that the act of Congress of September 8, 1916, was applicable to the trust.

The following is a summary of the facts stated narratively: On May 31, 1901, Henriette S. Lachman was the owner of 7,475 shares of the capital stock of the S. & H. Lachman Estate, a corporation. On that date she executed and delivered to Albert Lachman and Henry Lachman, her sons, the following instrument:

ALAMEDA, CAL., May 31, 1901.

To Albert Lachman and Henry Lachman, my sons:

This is to certify that I have delivered to you seven thousand four hundred and seventy-five (7,475) shares of the capital stock of the S. & H. Lachman Estate, represented by certificates numbers eleven (11), twelve (12), and thirteen (13) respectively, however, upon the following trust:

To pay to me during my lifetime, all the income earned and derived therefrom, and, upon my death to deliver two thousand four hundred and ninety (2,490) shares, respectively by certificates number eleven (11) unto Henry Lachman, thenceforth for his absolute property; two thousand four hundred and ninety-five (2,495) shares, represented by certificates number thirteen (13) unto Albert Lachman, thenceforth for his absolute property; and yourselves, to wit, Albert Lachman and Henry Lachman, to hold two thousand four hundred and ninety (2,490) shares, represented by certificate number twelve (12) upon my death, in trust paying the income derived therefrom unto my daughter, Rebecca, wife of Lea Metzger, and upon the death of my said daughter, the income and earnings derived from said two thousand four hundred and ninety (2,490) shares shall be held, or expended, by you, according to your judgment, for the benefit of my grandchildren, the children of my said daughter, Rebecca Metzger, and upon the youngest of said children attaining the age of majority, all the then surviving children of my said daughter, Rebecca Metzger, shall be immediately entitled to said two thousand four hundred and ninety (2,490) shares in equal proportions.

HENRIETTE LACHMAN.

The requirements of the deed were performed upon the contingencies occurring for which it provided.

On November 14, 1916, Henriette S. Lachman died, being then a resident of Alameda county, Calif., leaving an estate of the value of \$302,963.64, which included 2,490 shares of the stock that passed to her upon the death of her husband and 25 shares of stock in a business that had been conducted by her husband but did not include the transfer of the 4,985 shares included in the trust deed.

The will was duly probated and the tax under the act of September 8, 1916, was paid on the property which passed under her will, but no tax was paid on the 4,985 shares transferred 15 years before by the trust deed.

The commissioner having ruled that those shares were subject to a tax, assessed against them the sum of \$4,545.50. It was paid under protest and this action was brought for its recovery.

Wardell demurred to the complaint on the ground that it did not state facts sufficient to constitute a cause of action against them. The demurrer was sustained and judgment entered dismissing the complaint.

Stating the contention of the plaintiffs, the court said it was that "the act should not be construed as to include transfers made prior to its passage, and that if it be so construed the act is unconstitutional." The court observed that "both of these questions were determined adversely to the plaintiffs by the circuit court of Appeals for the eighth

circuit in *Schwab, executor, v. Doyle*, not yet reported." And said further, "in that case the transfer was made in contemplation of death, whereas in the present case the transfer was intended to take effect in possession or enjoyment at or after death, but manifestly the same rule of construction will apply to both provisions, and the same rule of constitutional validity."

The court, while apparently relying on *Schwab v. Doyle*, declared that it entertained "no doubt that the act was intended to operate retrospectively, and a contrary construction could only be justified on the principle that such a construction would render the act unconstitutional."

The same contentions are made against and for the ruling of the court as were made in *Schwab v. Doyle*. It is not necessary to repeat them. They are, with but verbal variations, the same as in *Schwab v. Doyle*, and the commissioner so considering, submits this case upon his brief in that.

We have there stated them and passed judgment upon that which we think determines the case; that is, the retroactivity of the act of September 8, 1916. The facts in this case fortify the reasoning in that. In this case the act is given operation against an instrument executed 15 years before the passage of the act.

The record exhibits proceedings that should be noticed. The demurrer of Wardell was sustained to the complaint, and a judgment of dismissal entered January 13, 1921.

On February 2, 1921, plaintiffs gave notice of a motion to substitute John S. Flynn as defendant in the place and stead of Wardell in so far as the action was against Wardell in his official capacity, and to permit it to be continued and prosecuted against him so far as it was against him personally.

The grounds of the motion were stated to be that he had resigned and Flynn had been appointed his successor and was then the acting collector.

On February 7, 1921, the motion was granted. The order of the court recited the resignation of Wardell and the succession of Flynn. And it being uncertain as to whether this was a proper case for the substitution of Flynn or was one which should proceed against Wardell, and it appearing to the court on motion of plaintiffs that it was necessary for the survivor to obtain a settlement of the questions involved, it was ordered that so far as the action was against Wardell in his official capacity, it might be sustained against Flynn as his successor, and that, so far as it was against Wardell personally, it should be continued against him. And it was ordered that the action should thereafter proceed against Flynn and Wardell without further pleadings or process.

On February 9, 1921, Flynn filed an appearance by attorneys which recited that he had been substituted in the place of Wardell in so far as the action was against Wardell in his official capacity, and thereby appeared in the action as such defendant.

It will be observed that there was no resistance to the motion of substitution of Flynn nor exception by him, and that he almost immediately appeared in the action in compliance with the order of the court. The subsequent proceedings were directed as much against him as against Wardell, the bond upon the writ of error running to both.

However, this court decided in *Smietanka, collector, v. Indiana Steel Co.*, October 24, of this term that a suit may not be brought against a collector of internal revenue for the recovery of a tax, in the collection and disbursement of which such officer had no agency. We think the bringing of Flynn into the case was error. Therefore, upon the return of the case to the district court, he shall be permitted to set up the

defense of nonliability, if he be so advised, and, if he set up the defense, it shall be ruled as sufficient for the reasons we have given.

Judgment reversed and cause remanded for further proceedings in accordance with this opinion.

(T. D. 3339—May 29, 1922)

Estate tax—Act of September 8, 1916—Decision of Supreme Court.

1. STATUTES—RETROACTIVITY—INTENTION.

Statutes will not be construed as retroactive unless that intention is clearly declared and the language makes such operation imperative.

2. SAME—TRANSFERS IN CONTEMPLATION OF DEATH.

Act of September 8, 1916, Title II, is prospective and not retroactive in operation and section 202 (b) thereof is therefore not applicable to transfers made or trusts created in contemplation of death prior to the passage of the act, though the maker of the transfer or the creator of the trust died subsequently thereto.

3. SAME—EFFECT OF SECTION 402, REVENUE ACT OF 1918.

The provision of section 402 of the revenue act of 1918, which reenacted section 202 of the act of September 8, 1916, that the transfer or trust should be taxed whether "made or created before or after the passage of the act," was not an elucidation of the act of September 8, 1916, but was the declaration of a new purpose, not the explanation of an old one.

The appended decision of the supreme court of the United States, dated May 1, 1922, in the case of *Victor E. Schwab, executor, v. Doyle, collector*, reversing the decision of the United States circuit court of appeals, sixth circuit (T. D. 3119), is published for the information of internal revenue officers and others concerned.

SUPREME COURT OF THE UNITED STATES. No. 200. OCTOBER TERM, 1921.

Victor E. Schwab, executor of the last will and testament of Augusta J. Dickel, deceased, plaintiff in error, v. Emanuel J. Doyle, United States collector of internal revenue for the fourth collection district of Michigan.

ERROR to the United States circuit court of appeals for the sixth circuit.

[May 1, 1922.]

Mr. Justice McKenna delivered the opinion of the court:

Augusta Dickel by a deed dated April 21, 1915, assigned and delivered to the Detroit Trust Co., stocks, bonds, or securities of the declared value of \$1,000,000—with all their unmatured coupons, and the proceeds to be derived therefrom, both principal and income, in trust, to invest and reinvest and to pay the net income for life to Victor E. Schwab, or on his written order. After his death the net income was directed to be paid to six beneficiaries, his children. A power of delegating and selling or exchanging all securities was given to Schwab, and of reinvestment. During the life of Schwab the net income was to be paid to him or his order. After his death the trust was to continue during the lives of the beneficiaries and the net income was to be paid to them during their respective lives in equal shares.

There were other rights and powers given to plaintiff and the beneficiaries not necessary to mention.

The trust deed was accepted by the Detroit Trust Co. on or before June 3, 1915.

Augusta Dickel died September 16, 1916, possessed of an estate of \$800,000. Seven days before her death Congress passed an act entitled "estate tax act" (39 Stat. 777-780). The act provided that according to certain percentages of the value of the net estate, a tax was to be imposed upon the transfer of the net estate of every decedent dying after the passage of the act, "to the extent of any interest therein of which the decedent has at any time made a transfer, or with respect to which he has created a trust, in contemplation of or intended to take effect in possession or enjoyment at or after his death, except in case of a bona fide sale for a fair consideration in money or money's worth. Any transfer of a material

part of his property in the nature of a final disposition or distribution thereof, made by the decedent within two years prior to his death, without such a consideration, shall, unless shown to the contrary, be deemed to have been made in contemplation of death within the meaning of this title. . . ."

Under the assumption that the act was applicable to the deed made by Augusta Dickel to the Detroit Trust Co. a tax was assessed and exacted from plaintiff in error (here called plaintiff) in the sum of \$56,548.41. Plaintiff paid it under protest and then to recover it brought this action in the district court of the United States for the western district of Michigan, southern division.

A jury being impaneled to try the case, the plaintiff presented his contentions in requests for charges. These were: (1) To find for plaintiff. (2) Upon refusal of the court to so charge but not otherwise, that the deed of Mrs. Dickel to the Detroit Trust Co. took effect more than a year before the enactment of the act of September 8, 1916; that is, took effect immediately, not in possession or enjoyment at or after the death of Mrs. Dickel. (3) The words "in contemplation of death" do not refer to that general expectation of death which every mortal entertains, but rather the apprehension which arises from some existing condition of body or some impending peril. (4) If Mrs. Dickel when she made the trust deed was not in that apprehension arising from that condition of body or of an impending peril, it was not made within the meaning of the act of congress. (5) Mrs. Dickel having made the deed before the act of congress was passed, her purpose was not to defeat or evade the federal revenue law.

There were other requests for instruction to the jury not material to be considered except that the act of congress was not retrospective in character and, therefore, did not impose a tax on the deed from Mrs. Dickel to the trust company. And that if it could be considered to have that character and effect, it would be unconstitutional and void as a denial of due process of law, and the taking of private property for public use without just compensation, contrary to the fourteenth amendment of the Constitution of the United States.

The court ruled against all of the requests so far as the court considered them as presenting questions of law, but considered that whether the trust deed was made in contemplation of death was a question for the jury and submitted it to them, with aiding and defining explanations, and concluded by declaring, "the whole question is the question whether the transfer was made in contemplation of death; that is all there is to it."

The verdict of the jury was in favor of the defendant, upon which judgment was duly entered. It was affirmed by the circuit court of appeals (269 Fed. 321), to the action of which this writ of error is directed.

Plaintiff urges against the judgment of the circuit court of appeals all of the contentions presented in his requests made to the district court for instructions to the jury, but so diverse and extensive consideration is only necessary if the act of congress be of retrospective operation. To that proposition we shall, therefore, address our attention.

The initial admonition is that laws are not to be considered as applying to cases which arose before their passage unless that intention be clearly declared. (1 Kent. 455; *Bidman v. Martinez*, 184 U. S. 578; *White v. United States*, 191 U. S. 545; *Gould v. Gould*, 245 U. S. 151; Story, *Const.* sec. 1398.) The comment of Story is, "retrospective laws are, indeed, generally unjust; and, as has been forcibly said, neither accord with sound legislation nor with the fundamental principles of the social compact."

There is absolute prohibition against them when their purpose is punitive; they then being denominated *ex post facto* laws. It is the sense of the situation that that which impels prohibition in such case exacts clearness of declaration when burdens are imposed upon completed and remote transactions, or consequences given to them of which there could have been no foresight or contemplation when they were designed and consummated.

The act of September 8, 1916, is within the condemnation.

There is certainly in it no declaration of retroactivity, "clear, strong, and imperative," which is the condition expressed in *United States v. Heth* (3 Cranch, 398, 415); also *United States v. Burr* (159 U. S. 78, 82-83).

If the absence of such determining declaration leaves to the statute a double sense, it is the command of the cases, that that which rejects retroactive operation must be selected.

The circumstances of this case impel to such selection. If retroactivity be accepted, what shall mark its limit? The circuit court of appeals found the interrogation not troublesome. It said, "Congress would, we think, scarcely be impressed with a practical likelihood that a transfer made many years before a grantor's death (say 25 years, to use plaintiff's suggestion) would be judicially found to be made in contemplation of death under the legal definition applicable thereto, and without the aid of the two years' *prima facie* provision." In other words, the sense of courts and juries, good or otherwise, might, against the words of the statute, and against what might be the evidence in the case, unhelpt by the presumption declared, fix the years of its retrospect. This would seem to make the difficulty or ease of proof a substitute for the condition which the statute makes necessary to the imposition of the tax; that is, the disposition with which the transfer is made; and certainly whether that disposition exist at an instant before death or years before death, it is a condition of the tax.

The construction of the government is more tenable though more unrestrained. It accepted in bold consistency, at the oral argument, the challenge of 25 years, and a ruling of the commissioner of internal revenue, in bolder confidence, extends the statute to "transfers of any kind made in contemplation of death at any time whatsoever (italics ours) prior to September 8, 1916." The sole test in the opinion of that officer is "the date of the death of the decedent." He fixes no period to the retrospect he declares, but reserves, if he be taken at his word, the transfers of all times to the demands of revenue. In this there is much to allure an administrative officer. Indeed, its simplicity attracts anyone. It removes puzzle from construction and perplexity and pertinence on account of the distance of death from the transfer, risking no chances of courts or juries, in repugnance or revolt, taking liberties with the act to relieve from its exactions to the demands of revenue.

If congress, however, had the purpose assigned by the commissioner it should have declared it; when it had that purpose it did declare it. In the revenue act of 1918 it reenacted section 202 of the act of September 8, 1916, and provided that the transfer or trust should be taxed whether "made or created before or after the passage of" the act. And we can not accept the explanation that this was an elucidation of the act of 1916, and not an addition to it, as averred by defendant, but regard the act of 1918 rather as a declaration of a new purpose; not the explanation of an old one. But granting the contention of the defendant has plausibility, it is to be remembered that we are dealing with a tax measure and whatever doubt exists must be resolved against it.

This we have seen is the declaration of the cases and this the basis of our decision; that is, has determined our judgment against the retroactive operation of the statute. There are adverse considerations and the government has urged them all. To enter into a detail of them or of the cases cited to sustain them and of those cited to oppose them, either directly or in tendency, and the examples of the states for and against them, would extend this opinion to repellant length. We need only say that we have given careful consideration to the opposing argument and cases, and a careful study of the text of the act of congress, and have resolved that it should be not construed to apply

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to transactions completed when the act became a law. And this, we repeat, is in accord with principle and authority. It is the proclamation of both that a statute should not be given a retrospective operation unless its words make that imperative, and this can not be said of the words of the act of September 8, 1916.

Judgment reversed.

(T. D. 3348—June 10, 1922.)

Estate tax—Revenue act of 1918—Decision of court.

1. SUIT TO ENJOIN COLLECTION OF TAX—REMEDY AT LAW.

Injunction will not issue to restrain a collector of internal revenue from collecting an estate tax imposed by the revenue act of 1918, title IV, on the ground that under section 408 of such act the executors of the estate had until the expiration of one year and 180 days after decedent's death in which to pay the tax, and that such executors were without adequate remedy at law. (*Nichols v. Gaston*, T. D. 3325, followed.)

SAME—APPEAL—EFFECT OF PAYMENT ON CONSIDERATION OF CASE ON MERITS.

Where costs have been decreed against a collector in the district court in a suit enjoining collection of a tax from which he would be relieved if the decree should be reversed, motion to affirm the decree or dismiss the appeal on the ground that, in view of the payment of the tax before hearing in the circuit court of appeals, the questions presented by the appeal were academic, will be denied, and the case will be considered on its merits.

The appended decision of the United States circuit court of appeals for the first circuit in the case of *Frank A. Page v. Frank L. Polk et al.*, reversing the decree of the district court of the United States for the district of Rhode Island, is published for the information of revenue officers and others concerned.

UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIRST CIRCUIT. No. 1544.

OCTOBER TERM, 1921.

Frank A. Page, individually and as collector of internal revenue, defendant, appellant, v. Frank L. Polk et al., executors, plaintiff, appellees.

APPEAL from the district court of the United States for the district of Rhode Island.

Before BINGHAM, JOHNSON, and ANDERSON, judges.

OPINION OF THE COURT.

[May 16, 1922.]

BINGHAM, Judge: This is an appeal from a final decree of the district court for Rhode Island in a suit in equity brought by Frank L. Polk and the United States Trust Co. of New York, executors of the estate of Josephine Brooks, against Frank A. Page individually and as collector of internal revenue for the district of Rhode Island, restraining the latter from collecting a tax assessed against the estate.

The complainants are citizens of New York and the defendant is a citizen of Rhode Island. Josephine Brooks died August 17, 1920. The complainants duly filed their return setting forth the value of the estate, and the commissioner of internal revenue assessed thereon a tax of \$245,787.67, under title IV of the revenue act of February 24, 1919 (Stat. L., p. 1096). The jurisdiction of the district court, as a federal court, is involved on the ground of diverse citizenship and that the amount involved exceeds \$5,000, exclusive of interest and costs; also on the ground that the suit is one arising under the internal revenue laws of the United States.

There is no controversy as to the legality or amount of the tax assessed against the estate. The complainants contend that under section 408 of the act of 1919 they are given a year and 180 days after their testatrix's death in which to pay the tax, even though the commissioner of internal revenue had not extended the time of payment under section 406 for

180 days after its due date, and that the defendant was not authorized to enforce its collection by distraint or otherwise until after the expiration of 180 days; that in violation of this right the defendant, pretending to act in his capacity as collector, on the 28th day of September, 1921, and before the 180 days had expired, notified the complainants that, unless the tax was paid within 10 days, he should proceed to collect the same, with costs, by seizure and sale of property; that under section 408 of the act of 1919 the collector is prevented from collecting the tax by distraint or otherwise within 180 days; and that the threatened seizure, if carried out, would have been unauthorized and an act not done by him in his official capacity or with color of law. They further contend and allege in their bill that if, to avoid such threatened distraint, they at this time paid the tax they would be remediless in law, as they had the privilege, under section 406, of paying the tax at any time down to February 13, 1922, without interest. It was also alleged in the bill that the payment of the tax at the time of the commencement of the suit rather than on February 13, 1922, would subject the estate to loss of interest on the money during the interim in excess of \$5,000 and would subject the estate to the difficulty of converting the assets into cash for immediate payment of a large sum of money. But it appears in the final decree that it was stipulated in open court that the complainants had, at the time of the commencement of the suit and at the time of entering the decree, assets in their hands sufficient to meet the tax, and that the loss which they would have sustained by the payment would have been the interest on the tax, unless they were able to recover it back from the United States.

It was decreed that the payment of the tax was "not required by law or compellable by distraint until one year and 180 days after the death of Josephine Brooks, which occurred on the 17th day of August, 1920;" that payment of the tax "at the time of the filing of the original bill herein, instead of in February, 1922 * * *, would have subjected the estate * * * to loss of interest on the money so paid during the interim, amounting to a sum in excess of \$5,000; and that if, to avoid the threatened distraint, the plaintiffs should themselves pay such tax prior to February 13, 1922, they would be remediless in the law." It was further decreed that the defendant, his agents and servants, be permanently restrained "from making or attempting to make any seizure, distress or distraint of the property of the complainants * * * until the expiration of the 13th day of February, 1922 (but no longer)," and "that the complainants recover of the defendant, Frank A. Page individually, the sum of \$46.54, their costs and disbursements herein duly taxed."

The bill of complaint was filed October 4, 1921. The final decree was entered December 27, 1921. A petition for appeal and assignment of errors was filed January 27, 1922, and on that day the appeal was allowed and citation issued returnable to this court February 24, 1922, the service of which was accepted January 27, 1922. The record was filed in this court February 9, 1922.

On February 10, 1922, the 180 days having nearly elapsed, the complainants paid the collector of internal revenue the tax in question.

When the case came on for hearing in this court the appellees (complainants) moved to affirm the decree or dismiss the appeal on the ground that, the tax having been paid, the questions presented by the appeal were academic. The appellant objected and now contends that the case should be considered on its merits and the decree reversed on the authority of our decision of March 21, 1922, in *Nichols v. Gaston et al.*, executors; that no other course can properly be taken as costs were awarded against him in the court below, which he has paid.

Costs having been decreed against the appellant from which he would be relieved if the decree should be reversed, we think the case must be considered on its merits.—Matter of application of *Martin v. W. J. Johnson Co.* (128 N. Y. 605).

The facts in this case, so far as they relate to the right of the appellees to restrain the appellant from collecting the tax, differ in no respect from those considered by us in *Nichols v. Gaston et al., executors*, supra, in which it was held that the injunction was improperly issued. We see no occasion for receding from the views there expressed and are of the opinion that the appellees' motion should be denied, the decree of the district court reversed, and costs awarded the appellant in this court and in the court below.

The decree of the district court is reversed and the case is remanded to that court with directions to enter a decree dismissing the bill, with costs to the appellant in this court and in the district court.

CONCURRING OPINION.

ANDERSON, judge. Sitting as district court on January 9, 1922, the case of *Gaston v. Nichols* came before me. It then appeared that the issue in that case was not distinguishable from the issue in the present case, in which, on November 17, 1921, Judge Brown had filed a careful opinion. It seemed plain that the question was one of substantial public importance that ought to be determined speedily by the court of appeals.

Manifestly, it would have been of no practical use for me, sitting as district court, to have studied the problem and formed and expressed an opinion agreeing or disagreeing with Judge Brown's views. Accordingly, in order to speed the cause, without hearing the question argued, I ruled, pro forma, as Judge Brown had ruled—the parties agreeing to coöperate in every practical way in obtaining an early hearing in this court.

On this appeal in *Page v. Polk* I have for the first time considered the question and examined the authorities. My views accord with the decision of this court in *Nichols v. Gaston* and in the instant case.

Accountants' Meeting in Seattle

A meeting of members of the Oregon and Washington Societies of Certified Public Accountants and the Institute of Chartered Accountants of British Columbia was held at the Rainier Club, Seattle, on June 16th, by invitation of the Washington society.

The meeting was devoted principally to social affairs, and there were few formal discussions. The programme consisted of music, entertainment, an address of welcome by Harry W. Carroll, an address by A. L. C. Chalk on conditions in Canada; Arthur Berridge of Portland spoke on the subject of coöperation, and W. E. Cox of the accounting department of the school of business administration of the University of Washington delivered an address on accounting as a profession. Dinner was held at the Arctic Club.

Certified Public Accountants of Massachusetts, Inc.

At the annual meeting of the Certified Public Accountants of Massachusetts, Inc., held May 22nd, the following officers were elected: President, Hollis E. Sawyer; vice-president, Stanley G. H. Fitch; secretary, Frederick Bond Cherrington; treasurer, Robert Douglas; three members of the executive committee: J. Edward Masters, Charles F. Rittenhouse and George Lyall.

D. D. Gearhart announces the opening of an office at 1139 Granite building, Rochester, New York.

Students' Department

EDITED BY H. A. FINNEY

INSTITUTE EXAMINATIONS

(NOTE—The fact that these solutions appear in THE JOURNAL OF ACCOUNTANCY should not lead the reader to assume that they are the official solutions of the American Institute of Accountants. They merely represent the personal opinion of the editor of the *Students' Department*.)

EXAMINATION IN ACCOUNTING THEORY AND PRACTICE—PART II

May 19, 1922, 1 P. M. to 6 P. M.

The candidate must answer the first four questions and one other question.

No. 1 (30 points):

The K & L Motors Company, a close corporation, whose records show assets amounting to \$9,090, exclusive of goodwill, and liabilities of \$3,330, is reorganized with an authorized capital stock of \$500,000, \$100,000 of which is issued to the stockholders of the old company in lieu of their present holdings, the balance to be issued as circumstances warrant.

The company (reorganized) commences business on the first day of March, 1920, under new management—transferring the balances noted above—and begins to dispose of its capital stock at a sacrifice in order to provide working capital. The funds provided by this means are expended quite freely in an attempt to exploit the business. At the end of the period of nine months (November 30, 1920), the sales of capital stock having fallen off considerably, the company is in difficulty.

The balances on the books at this date are as follows:

	Dr.	Cr.
Machinery and fixtures	\$ 3,959	
Tools and supplies	3,758	
Demonstration equipment	1,550	
Material and parts inventory, commencement	1,911	
Patterns	2,413	
Patents	419	
Office furniture and fixtures	1,611	
Cash in bank	6,280	
Petty cash, executive office	153	
Petty cash, factory	17	
Notes receivable	1,875	
Accounts receivable	26,881	
Insurance premiums unexpired	439	
Notes payable		\$23,500
Accounts payable		9,587
Loans, bank		4,784
Loans, personal		15,467
Royalties, due and unpaid		564
Salaries due and unpaid		500
Commissions due and unpaid		265
Capital stock authorized		500,000
Capital stock unissued	319,660	
Discount on capital stock	35,364	
Goodwill	94,240	
Contract orders outstanding		8,792

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Purchases:

Material and parts for tractors	63,369
Material and parts for trailers	351
Material and parts for 5th-wheel tractors	6,970
Material and parts for repairs	714
Material and parts for power-belt attachment	27

Sales:

5th-wheel tractors	1,125
Farm tractors	64,350
Power-belt attachments	17
Material and parts	4,377
Labor	1,027
Incidentals	180

Rent, factory	1,745
Rent, executive office	974
Salaries, executive office	3,430
Salaries, factory office	1,511
Management, factory	4,500
Foremen	1,419
Labor (wages)	10,183
Power, light and heat	376
Demonstration	811
Maintenance, equipment	316
Advertising	10,746
Printing and stationery	2,045
Freight and storage	4,209
Drafting	82
Telephone and telegrams	592
Traveling	2,245
Commissions	7,842
Insurance	234
Collections and exchanges	44
Shipping	268
Interest	238
Royalties	750
Discounts and allowances	544
Professional services	600
Advances against commissions	685
Advances for traveling	1,526
Incidentals, manufacturing	1,800
Incidentals, sales department	714
Incidentals, office	385
Reorganization expenses	1,760

The inventories at November 30, 1920, were:

Material and parts:

For farm tractors and miscellaneous	\$29,234
5th-wheel tractors	9,642
Repairs	1,150
	\$40,026

The management, realizing that a heavy loss has been sustained, conceives the idea of capitalizing a large portion of its expenses in order to make a more favorable statement to present to its bank in an application

for a loan, and the bookkeeper is instructed to make the journal entry as follows:

"Foundation" account	\$35,399
To sundries:	
Reorganization expenses	\$1,760
Salaries, executive office	1,697
Salaries, factory office	1,304
Labor (wages)	7,419
Management, factory	3,500
Foremen	1,049
Rent, executive office	641
Rent, factory	1,345
Power, light and heat	300
Maintenance, equipment	273
Demonstration	623
Drafting	76
Collections and exchanges	14
Incidentals, office	261
Incidentals, manufacturing	1,619
Incidentals, sales department	40
Advertising	6,300
Freight and storage	3,112
Shipping	31
Telephone and telegrams	376
Printing and stationery	1,522
Discounts and allowances	409
Traveling	1,030
Commissions	698

"Transferring the foregoing expense accounts respectively maintained to and including September 30, 1920, to foundation account, said expenses being incurred in the establishment of the Forma-Tractor, etc., on 'the market,' the effectiveness thereof being apparent from October 1, 1920, in the marked increase of sales as shown by the books."

An accountant is then asked to prepare balance-sheet and operating account from the adjusted trial balance and to certify thereto. He prepares the statements as requested but refuses a certificate, giving his reasons, although the management contends that it is justified in its request and cites two instances in which requests under similar conditions received favorable consideration. The accountant, however, presenting facts in his report, takes occasion to refer to the increase of sales during the last two months as probably the result of the expenditures in "pioneering."

You are asked to prepare the statements, balance-sheet and operating account, giving particular attention to the proper classification in each and to comment briefly upon the attitude of the accountant and the contention of the management.

NOTE—Do not waste time in making unnecessary transcripts of lists of balances placed before you.

Solution: The problem is vague on the point as to whether the candidate is expected to prepare the statements by giving effect to the company's foundation-account entry or statements without giving effect thereto. As far as I can see, one guess is as good as another, and my guess is that effect is not to be given to the entry. I make this guess because of the expressed insistence upon correct classification, and it would seem that correct content would be equally important.

While proper classification is demanded, insufficient information is given to enable the candidate to be sure in all cases that his classification is correct. Are the royalties based on the quantity manufactured or on the

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quantity sold? In the first case, they are a manufacturing expense; in the second case, they are a selling expense. There is an account with freight and storage and another with shipping. I assume that the first is equivalent to freight in and storage of goods before manufacture and treat it as an addition to purchases, and that the shipping account is equivalent to freight out and treat it as a selling expense. Are the traveling expenses and the commission expenses connected with the sale of product or the sale of stock?

Making the necessary assumptions, the statements appear as follows:

THE K & L MOTORS COMPANY (Exhibit A)

Statement of Cost of Goods Manufactured and Sold

March 1, 1920, to November 30, 1920

Materials:

Inventory, material and parts, March 1			\$ 1,911.00
Purchases, material and parts:			
For tractors	\$63,369.00		
For trailers	351.00		
For 5th-wheel tractors	6,970.00		
For repairs	714.00		
For power-belt attachment	27.00		
Total	\$71,431.00		
Add freight and storage	4,209.00	75,640.00	
Total		77,551.00	
Less material and parts inventories, November 30:			
For farm tractors and miscellaneous	29,234.00		
For 5th-wheel tractors	9,642.00		
For repairs	1,150.00	40,026.00	\$37,525.00
Direct labor			10,183.00

Manufacturing expense:

Rent, factory	\$ 1,745.00		
Salaries, factory office	1,511.00		
Management, factory	4,500.00		
Foremen	1,419.00		
Power, light and heat	376.00		
Maintenance, equipment	316.00		
Drafting	82.00		
Insurance	234.00		
Royalties	750.00		
Incidentals, manufacturing	1,800.00	12,733.00	
Total cost of goods manufactured and sold			60,441.00

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THE K & L MOTORS COMPANY Income and Profit-and-Loss Statement March 1, 1920, to November 30, 1920

(Exhibit B)

Gross proceeds from sales and service:

5th-wheel tractors	\$ 1,125.00	
Farm tractors'	64,350.00	
Power-belt attachments	17.00	
Material and parts	4,377.00	
Labor	1,027.00	
Incidentals	180.00	\$71,076.00
Less discounts and allowances		544.00
<i>Net proceeds from sales and service</i>		70,532.00
Deduct cost of goods sold (exhibit A)		60,441.00
<i>Gross profit</i>		10,091.00
Deduct selling expenses:		
Demonstration	811.00	
Advertising	10,746.00	
Traveling	2,245.00	
Commissions	7,842.00	
Shipping	268.00	
Incidentals	714.00	22,626.00
<i>Net loss on sales</i>		12,535.00
Add general expenses:		
Rent, executive office	974.00	
Salaries, executive office	3,430.00	
Printing and stationery	2,045.00	
Telephone and telegrams	592.00	
Collections and exchanges	44.00	
Professional services	600.00	
Incidentals, office	385.00	8,070.00
<i>Net loss on operations</i>		20,605.00
Add financial expense:		
Interest		238.00
<i>Net loss for nine months</i>		20,843.00

THE K & L MOTORS COMPANY Balance-sheet—November 30, 1920

(Exhibit C)

Assets

Fixed assets:

Goodwill	\$94,240.00	
Machinery and fixtures	3,959.00	
Tools and supplies	3,758.00	
Demonstration equipment	1,550.00	
Patterns	2,413.00	
Patents	419.00	
Office furniture and fixtures'	1,611.00	\$107,950.00

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Current assets:

Inventories—material and parts:

For farm tractors and miscellaneous	\$29,234.00	
5th-wheel tractors	9,642.00	
Repairs	1,150.00	40,026.00
Notes receivable		1,875.00
Accounts receivable		26,881.00
Advances against commissions'		685.00
Advances for traveling		1,526.00
Cash in bank		6,280.00
Petty cash		170.00
		77,443.00

Deferred charges:

Unexpired insurance	439.00	
Discount on capital stock	35,364.00	
Reorganization expense	1,760.00	37,563.00
		<u>\$222,956.00</u>

Liabilities

Current liabilities:

Notes payable	\$23,500.00	
Accounts payable	9,587.00	
Loans, bank	4,784.00	
Loans, personal	15,467.00	
Royalties due and unpaid	564.00	
Salaries due and unpaid	500.00	
Commissions due and unpaid	265.00	
Contract orders outstanding	8,792.00	63,459.00

Capital:

Capital stock authorized	\$500,000.00	
Less unissued stock	319,660.00	
	<u></u>	
Stock issued	180,340.00	
Deduct deficit (exhibit B)	20,843.00	159,497.00
		<u>\$222,956.00</u>

No provision has been made for depreciation of fixed assets nor for loss from bad debts.

It is probable that a compromise should be reached between the attitude of the company and the attitude of the accountant, but the bank should be informed of the facts and of the action taken, because the bank has the right to obtain the facts and be the final judge. There is considerable justice to the claim that promotion expenses should not all be charged off against the lean profits of the promotion period, but on the other hand a sharp distinction should be made between promotion and operation expenses.

It is certainly unjustifiable to carry forward expenses which are elements of the cost of manufacture. This would eliminate the following items from the foundation-account journal entry: salaries—factory office, labor, management—factory, foremen, rent—factory, power, light and heat, maintenance of equipment, incidentals—manufacturing, freight and storage.

It is also unjustifiable to carry forward expenses connected with sales already made, which would eliminate incidentals of sales department, shipping, discounts and allowances and commissions.

There are some items which might be carried forward if the conditions warrant it, although there is not enough information to enable one to be certain in each case. Reorganization expense has a pretty clear case in its favor. Demonstration, advertising and traveling expense may have been incurred in the development of a market which has only begun to make itself productive. Drafting expense may be virtually a capital expenditure.

A less clear case might be made out in favor of certain items of administrative expense, such as executive salaries, but there seems no justification whatever for a wholesale deferring of all expenses up to September 30th.

No. 2 (27 points):

A. B. and members of his family own all the capital stock of the A. B. Manufacturing Company. They have entered into an agreement with C. D. whereby he is to form a new corporation—the C. D. Company, Inc.—which will acquire the A. B. Manufacturing Company, taking over its assets and assuming its liabilities. The A. B. Manufacturing Company's balance-sheet appears as follows:

<i>Assets</i>	
Plant, less depreciation (book value)	\$1,000,000.00
Cash	50,000.00
Accounts receivable	200,000.00
Inventories	600,000.00
Deferred charges (insurance, etc.)	5,000.00
	\$1,855,000.00

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Liabilities

Capital stock, common	\$1,250,000.00
Notes payable	200,000.00
Accounts payable and accruals	250,000.00
Surplus	155,000.00
	\$1,855,000.00

The terms of the agreement are:

(1) For their present holdings and surplus of the A. B. Manufacturing Company, A. B. and his family shall receive common stock and 7 per cent. preferred stock in equal amounts at par. The present holdings and surplus of the A. B. Manufacturing Company shall be determined by an examination to be made by a certified public accountant, after substituting for the book value of the plant the appraised value of \$1,375,000.

(2) A. B. and his family are also to receive shares of common stock of \$100 each par value for the goodwill, which is to be considered as equivalent to three times the average annual net profits of the previous five years before charging interest and taxes.

(3) C. D. is to subscribe for \$500,000 of twenty-year bonds of the new corporation to be issued at 95 net to the corporation, the discount to be capitalized and to be amortized over the life of the bonds.

(4) The expenses of the organization of the new corporation are to be borne by it and are to be capitalized temporarily and written off during the next three years.

The profits, as adjusted by the auditor, were:

First year	\$ 60,000.00
Second year	80,000.00
Third year	100,000.00
Fourth year	125,000.00
Fifth year	135,000.00

and the necessity was reported for (1) a reserve for bad and doubtful accounts of \$12,000; (2) a reduction in the amount of inventories of \$24,000 for obsolete stock, errors, etc., and (3) an increase of \$1,500 accounts payable for expense invoices not recorded.

Prepare a statement in columnar form showing:

(a) The balance-sheet of the A. B. Manufacturing Company, as shown above without adjustments,

(b) The adjustments and financing in accordance with the contractual arrangements, and

(c) The balance-sheet of the C. D. Company, Inc., after giving effect to all adjustments and financing required under the contractual arrangements.

Solution:

STATEMENT SHOWING FULFILMENT OF CONTRACTUAL ARRANGEMENTS
BETWEEN THE A. B. MANUFACTURING COMPANY AND THE C. D. COMPANY, INC.

The A. B. Manufacturing Company		C. D. Co., Inc.	
ASSETS	Original balance-sheet	Adjusted balance-sheet	Financing adjustments
	Dr.	Cr.	Dr. Cr.
Plant	\$1,000,000	\$1,375,000	.....
Cash	50,000	50,000	.....
Accounts receivable	200,000	200,000	.....
Inventories	600,000	576,000	.....
Deferred charges	5,000	5,000	.....
	<u>\$1,855,000</u>		
Goodwill		300,000	.....
		<u>\$2,506,000</u>	
Bond discount			25,000 F
			<u>25,000</u>
			<u>\$3,006,000</u>
LIABILITIES			
Capital stock—common	\$1,250,000	\$1,250,000	.....
Notes payable	200,000	200,000	.....
Accounts payable and accruals	250,000	251,500	.....
Surplus	155,000	492,500	.....
			
	<u>\$1,855,000</u>		
Surplus—for goodwill		300,000 B	.....
Reserve for bad debts		12,000 C	.....
		<u>\$712,500</u>	
Bonds payable			\$500,000 F
Preferred stock—7%			871,250 G
Common stock			871,250 G
			300,000 H
			<u>\$2,542,500</u>
			<u>\$3,006,000</u>

Explanation of adjustments:

- (A) Debit plant; credit surplus to raise plant to appraised value.
- (B) Debit goodwill; credit surplus. Total profits for five years, \$500,000. Average, \$100,000. Three years' purchase, \$300,000. This surplus credit is separated from the other surplus because this credit is to be liquidated by common stock, while the general surplus is to be liquidated by equal portions of preferred and common stock.
- (C) Debit surplus; credit reserve for bad debts.
- (D) Debit surplus; credit inventories.
- (E) Debit surplus; credit accounts payable.
- (F) Debit cash and bond discount; credit bonds payable.
- (G) Debit capital stock and surplus; credit common stock and preferred stock in equal amounts.
- (H) Debit surplus; credit common stock.

No. 3 (10 points):

An expression of your opinion is desired regarding the following:

- Is it legal or sound business policy under any conditions for a corporation to declare a dividend out of current earnings while its capital is impaired?
- Is it ever justifiable to pay dividends with borrowed money?

Answer: It is illegal in the United States to declare a dividend out of current earnings while the capital is impaired through prior losses. Therefore it would not be sound business policy to declare a dividend under such conditions. On the other hand, it is permissible to declare a dividend out of current earnings before organization expense and stock discount accounts are completely amortized, and it might be good business policy to do so if the current earnings are adequate to provide for amortization of such accounts, protection of working capital and distribution of cash to stockholders.

Corporations engaged in the exploitation of natural resources and other depleting assets are not required to maintain their capital intact before paying dividends. That is, the corporation may pay dividends equal to the sum of its profits and the credit balance of its depletion reserve. It would be sound business policy to do so if the corporation does not intend to acquire another deposit to work after exhausting its present holdings.

As to the justifiability of paying dividends with borrowed money, it is necessary to make a distinction between the legal right to do so and the financial expediency of doing so. There is no question as to the legal right. The right to declare dividends depends upon the condition of the surplus account, not upon the condition of the cash account. It would probably be good policy to declare dividends and borrow money for their payment in case the failure to pay a dividend would adversely affect the standing of the company with the public and with its own stockholders, and in case the liquidation of the liability would not cripple the company through a depletion of its working capital. It is of course assumed that the company has sufficient surplus to warrant the declaration of the dividend.

No. 4 (10 points):

What is the significance of the item on the assets side of a balance-sheet usually described as "prepaid or deferred charges" and of that on the liabilities side as "wages and other expenses accrued"?

Answer: Prepaid or deferred charges are debits to expense accounts representing expenditures for business benefits which have not been wholly

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utilized and should be carried forward as assets to be written off against the profits of the future period which will receive the benefit of the expenditures.

Wages or other expenses accrued are liabilities for services enjoyed or benefits received which have not been paid for, but the liability has been recorded by a credit to a liability account to appear on the balance-sheet, while the offsetting debit has been made in an expense account so that the revenue account will include all expenses of the period, whether paid for or not.

No. 5 (23 points):

The X Corporation, under contract, furnishes the M Company part of its raw material. This contract at expiration will not be renewed. The M Company, unable to purchase this particular material elsewhere, decides to buy an unused plant and to equip it with the necessary machinery with which to produce the required material.

To help finance this purchase and to acquire enough raw material for the new plant, the company borrows from its bankers \$25,000 prior to December 31, 1919, and \$175,000 during 1920. Of this amount \$45,000 has been repaid in 1920, leaving a balance of \$155,000 due the bankers on December 31, 1920.

This loan has been in the form of short-term notes which are renewed from time to time.

On December 31, 1920, the bankers suggest to the M Company that, inasmuch as the loan was principally invested in the fixed assets of the company, it should be converted into a mortgage bond issue.

The M Company, which is a close corporation, feels that, while the loan did help finance the plant purchase, it is now practically financing the current operations and the company wishes you to use the two accompanying balance-sheets and other information derived therefrom to formulate a report which it may present to its bankers in support of its views.

Prepare such statements as you think necessary and draft a letter explaining how such statements support the views of the M Company.

THE M COMPANY Balance-sheet—December 31, 1919 and 1920

	December 31	
	1919	1920
<i>Assets</i>		
Cash	\$ 37,000.00	\$ 36,000.00
Receivables'	118,000.00	152,000.00
Inventories	231,000.00	360,000.00
Machinery and equipment	82,000.00	101,000.00
Buildings	58,700.00	116,500.00
Land	45,800.00	68,500.00
Deferred charges	3,850.00	22,300.00
	<u>\$576,350.00</u>	<u>\$856,300.00</u>
<i>Liabilities</i>		
Accounts payable	\$ 1,800.00	\$ 26,000.00
Accrued federal taxes*	4,300.00	26,800.00
Notes payable—banks	25,000.00	155,000.00
Reserve for depreciation	37,200.00	42,510.00
Capital stock	400,000.00	400,000.00
Surplus**	108,050.00	205,990.00
	<u>\$576,350.00</u>	<u>\$856,300.00</u>

* Federal taxes were computed and charged against profits before closing the books each year.

** No dividends were paid in 1920.

Students' Department

Solution.

THE M COMPANY Comparative balance-sheet

<i>Assets</i>				
	Dec. 31, 1919	Dec. 31, 1920	Decrease	Increase
Cash	\$ 37,000.00	\$ 36,000.00	\$ 1,000.00	
Receivables	118,000.00	152,000.00		\$ 34,000.00
Inventories	231,000.00	360,000.00		129,000.00
Machinery and equipment	82,000.00	101,000.00		19,000.00
Buildings	58,700.00	116,500.00		57,800.00
Land	45,800.00	68,500.00		22,700.00
Deferred charges	3,850.00	22,300.00		18,450.00
	<u>\$576,350.00</u>	<u>\$856,300.00</u>		
Increase in assets			279,950.00	
			<u>\$280,950.00</u>	<u>\$280,950.00</u>
<i>Liabilities</i>				
Accounts payable	\$ 1,800.00	\$ 26,000.00		\$ 24,200.00
Accrued federal taxes ..	4,300.00	26,800.00		22,500.00
Notes payable—banks ..	25,000.00	155,000.00		130,000.00
Reserve for depreciation	37,200.00	42,510.00		5,310.00
Capital stock	400,000.00	400,000.00		
Surplus	108,050.00	205,990.00		97,940.00
	<u>\$576,350.00</u>	<u>\$856,300.00</u>		
Increase in liabilities and surplus			279,950.00	
			<u>\$279,950.00</u>	<u>\$279,950.00</u>

THE M COMPANY

Statement of application of funds for the year ending December 31, 1920

Funds provided:

By profits:

Net profit per books	\$ 97,940.00
Add back depreciation, which was a charge against profits not requiring expenditure of funds	5,310.00
Total	<u>\$103,250.00</u>

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Funds applied:

To increase in fixed assets:

Machinery and equipment	\$19,000.00	
Buildings	57,800.00	
Land	22,700.00	99,500.00

To increase in working capital and deferred charges 3,750.00

Total \$103,250.00

THE M COMPANY

Schedule of working capital and deferred charges

Current assets:	Dec. 31, 1919	Dec. 31, 1920	Change in working capital	
			Decrease	Increase
Cash	\$ 37,000.00	\$ 36,000.00	\$ 1,000.00	
Receivables	118,000.00	152,000.00		\$ 34,000.00
Inventories	231,000.00	360,000.00		129,000.00
Deferred charges	3,850.00	22,300.00		18,450.00
Total	<u>\$389,850.00</u>	<u>\$570,300.00</u>		
Increase in working assets			180,450.00	
			<u>\$181,450.00</u>	<u>\$181,450.00</u>
Increase in working assets—down				<u>\$180,450.00</u>
<i>Current liabilities:</i>				
Accounts payable	\$ 1,800.00	\$ 26,000.00	\$ 24,200.00	
Accrued federal taxes.	4,300.00	26,800.00	22,500.00	
Bank loans	25,000.00	155,000.00	130,000.00	
Total	<u>\$ 31,100.00</u>	<u>\$207,800.00</u>		
Working capital	<u>\$358,750.00</u>	<u>\$362,500.00</u>		
Increase in working capital and deferred charges			3,750.00	
			<u>\$180,450.00</u>	<u>\$180,450.00</u>

Gentlemen: The enclosed statement of application of funds shows that the net profits for the year 1920 produced funds of \$103,250. The total expenditures for fixed assets amounted to \$99,500, so that the profits were sufficient to provide for the increase in fixed assets and leave an excess of

Students' Department

\$3,750 which was applied to the increase of working capital, necessitated by the extension of the plant.

The working assets increased \$180,450, as shown by the schedule of working capital and deferred charges. This increase in assets was provided for as follows:

By net profits in excess of capital expenditures	\$	3,750.00
By increase in bank loans		130,000.00
By increase in other current liabilities:		
Accounts payable	\$24,200.00	
Accrued federal taxes	22,500.00	46,700.00
Total		<u>\$180,450.00</u>

These statements seem clearly to substantiate the claim that the profits financed the capital expenditures and that the bank loans are financing the current operations.

Yours truly,
X. Y. Z.

No. 6 (23 points):

An audit of a set of accounts in order to determine the true profits for the years 1920 and 1921 revealed the following:

On the books of the home office, the account "branch office account current" shows a debit balance of \$12,250 at December 31, 1920, which was erroneously written off to profit-and-loss. At December 31, 1921, a credit balance of \$2,050 was shown and this also was transferred to profit-and-loss.

An examination of the branch office records disclosed the keeping of asset and liability as well as revenue and expense accounts, and a balance-sheet, as at December 31, 1920, showed a net worth of \$17,700 credited to the home office. Another balance-sheet, as at December 31, 1921, showed a net worth of \$8,500.

Before closing of revenue and expense accounts for 1920, the relative accounts on both home office and branch books were in agreement, except that a draft of \$1,500 drawn and recorded by the branch in 1920 was paid and recorded by the home office in 1921.

The results of the closing of the branch office accounts had not been recorded on the home-office books.

Make required adjustments and state

- (a) What effect said adjustments would have on the profit showing for each of the years 1920 and 1921 on the home-office books and
- (b) What correction is necessitated in the amount of invested capital, December 31, 1920.

Solution: The books can be adjusted by a single journal entry as follows:

Branch-office current account	\$8,500.00	
Surplus		\$8,500.00

To raise the branch current account to the amount of the net assets at the branch at December 31, 1921, and to adjust the surplus account.

The debit to branch-office current account needs little explanation. The account is closed at December 31, 1921, when it should have a balance of \$8,500, the amount of net assets at the branch at that date.

The credit to surplus requires more explanation.

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The true profits for the two years may be computed as follows:

Profits for 1920:

The net assets at the branch at Dec. 31, 1920, were	\$17,700.00
The branch current account on the home-office books had a debit balance of	\$12,250.00
If the home office had taken up the draft for	1,500.00
the balance of the current account would have been	13,750.00
The profits were therefore	3,950.00

Profits of 1921:

The branch current account on the home-office books at Jan. 1, 1920, should have had a debit balance of	\$17,700.00
During 1921 the net credits to the current account have been	\$ 2,050.00
But this is net after charging the current account with the draft of	1,500.00
As this draft was considered in determining the opening balance of \$17,700, it is eliminated from the 1921 entries, making the result of the 1921 entries a net credit to the current account of....	3,550.00
This would reduce the balance of the current account to	14,150.00
But the net assets at the branch are only	8,500.00
Hence there has been a loss during the year of ..	\$5,650.00

SUMMARY

1920:

Charge to profit-and-loss	\$12,250.00
True profit	3,950.00
Understatement of profits, surplus and invested capital	\$16,200.00

1921:

Credit to profit-and-loss	\$ 2,050.00
True loss	5,650.00
Overstatement of year's profit	7,700.00
Total under-statement of profits, now credited to surplus	\$8,500.00

It must be understood that the \$16,200 addition to invested capital affects the taxable year 1921.

Terminology Department

CONDUCTED BY THE SPECIAL COMMITTEE ON ACCOUNTING TERMINOLOGY
OF THE AMERICAN INSTITUTE OF ACCOUNTANTS

The letters received as a result of the previous articles in this department of THE JOURNAL OF ACCOUNTANCY contain valuable suggestions and expressions of a desire to coöperate in the work of the committee and it is hoped that further frank criticisms and suggestions will be received.

Terminology is also receiving the attention of such bodies as the American Association of University Instructors in Accounting and the National Association of Cost Accountants, and *The Cost Accountant*, which is an English journal devoted to "costing," has had a number of communications on the subject.

The committee publishes below a list of words indicating the various kinds of bonds, dividends and companies and/or corporations. The two latter root words have been merged at this time, pending additional information from different sections of the country as to their relative use. Some of the derivatives are used almost solely as descriptive of one or the other root word, some used interchangeably with either, while still others are used more commonly with one than with the other.

BOND			
active	conditional	first and general	issued and out-
actually issued	consolidated	mortgage	standing
adjustment	consolidated	first mortgage	jail
adjustment	mortgage	first mortgage trust	joint
mortgage	construction	first and refunding	joint stock land
annuity	continued	mortgage	bank
assented	convertible	floating	joint collateral trust
assumed	convertible collat-	forthcoming	judgment
authorized	eral trust	free	junior
authorized and	corporation	funding and real	junior lien
issued	coupon	estate mortgage	land grant
authorized and	currency	general first	large
unissued	debenture	mortgage	legal tender
baby	deferred	general mortgage	Liberty
bail	definitive	gold	Lloyd's
bearer	ditch	government	long term
blanket mortgage	dividend sharing	guaranteed	long time
bonus	divisional	improvement	lottery
bottomry	dollar	improvement	mortgage
called	drainage	mortgage	municipal
cancelled	drawn	inactive	nominally issued
car trust	employees'	income	nominally
charter	equipment	indemnity	outstanding
classified	equipment trust	indorsed	non assented
collateral	escrow	instalment	obligatory
collateral	exchequer	intersecting sewer	official
participating	extended	interchangeable	optional
collateral income	extension	interest	overlying
collateral mortgage	external	interim	participating
collateral trust	federal land bank	intersecting street	passive
common law	fidelity	improvement	penal
	first and consoli-	irredeemable	plain
	dated mortgage	irrigation	post obit

preference	special revenue	Irish	industrial
prior lien	stamped	liquidating	insurance
profit sharing	state	liquidation	joint stock
purchase money	statutory	non cumulative	limited
ragged	straight city	paid	limited liability
rail aid	street improvement	passed	manufacturing
real estate	subscribed	property	mining
reclamation	tax relief	scrip	municipal
redeemable	terminal	securities	mutual
redelivery	terminal mortgage	stock	non-operating
redemption	title	unclaimed	non stock
refunding	treasury	unearned	one man
refunding mortgage	unassented	unmatured	operating
registered	underlying	unpaid	parent
registered coupon	unified		personal service
rehabilitation	unsecured		private
released indorsed	unsubscribed	COMPANY and	proprietary
renewal	water	/or CORPORA-	public
reorganization	water company	TION*	public service
respondentia			public utility
revenue			quasi municipal
second consolidated	DIVIDEND	affiliated	safe deposit
mortgage	accrued	agricultural	securities
second mortgage	accumulated	allied	security
secured	bond	associated	stock
serial	bonus	bonding	sub
short term	cash	close	subsidiary
short time	cumulative	commercial	surety
simple	declared	controlled	system
sinking fund	deferred	controlling	trading
small	equalizing	eleemosynary	transportation
special aid	ex	finance	trust
special assessment	extra	financial	underlying
special asset	interim	holding	unlimited
		indemnity	

* The above list is confined to types of companies or corporations or to terms descriptive of their general characteristics.

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F. F. WHITE

As this magazine is going to press, advice is received that F. F. White died in Devonshire, England, July 21, 1922.

Mr. White was for many years a partner of Deloitte, Plender, Griffiths & Co. and was well known among the accountants in both England and America. He had been a member of council of the American Institute of Accountants and at one time was chairman of its committee on professional ethics. His death occurred after a long illness.

Book Reviews

THE ACCOUNTANTS' DICTIONARY, edited by FRANCIS W. PIXLEY.
Sir Isaac Pitman & Sons, London and New York. 2 vols. 989 pages.

At a time when accounting terminology is being so widely considered as to receive official consideration by the American Institute of Accountants and THE JOURNAL OF ACCOUNTANCY in this country and by *The Cost Accountant* in London, the appearance of a new dictionary is sure to attract attention. The present volumes are edited by the distinguished author, Mr. Pixley, who has written among other works *Auditors, Their Duties and Responsibilities*, which has for many years been regarded in Great Britain as the leading authority in its own field. The editor has been assisted by nineteen "highly qualified members of the accounting and legal professions," amongst whom are some of the best known British accountants.

The fact that the work is written by practitioners in Great Britain for British readers naturally leads to the treatment of many subjects in a British manner and to the inclusion of British procedure, which is not of direct use to American readers, e.g., many pages are devoted to bankruptcy matters, to British income tax, to executors' accounts and to some other similar subjects, in which the procedure is determined by law. Such inclusions, however, are not entirely useless to American readers for they present in a convenient and condensed form much information which practising accountants occasionally need, while comparison with foreign methods affords excellent practice for the student. The majority of expressions appear in alphabetical order, but many of the important matters are treated in groups, e.g., under balance-sheet we find a discussion of the usual accounts found therein, such as reserves, sinking funds, plant and machinery, etc., while the trading account and profit-and-loss account are treated similarly, the result being to bring in one place a discussion of the usual items included under the main subject. This arrangement facilitates a broad view of the entire question and illustrates the amount of information given beyond mere definitions.

The reader expecting to find many new principles enunciated may be disappointed, but if he also seeks sound information on a great variety of accounting subjects, he will be well rewarded. It must be remembered that one does not consult a dictionary in search of novelty so much as to obtain an accurate and authoritative statement.

On account of my work for the American Institute of Accountants in connection with terminology, I admit to some disappointment at the absence of a full discussion of some of those balance-sheet and profit-and-loss terms which are used so indiscriminately, such as net and gross profits, earnings, surplus, etc. There is also disappointment at the omission from the list of other words frequently used in this country, such as accountant, accountancy, fund, auditor, accruals, obsolescence and turnover. On the other hand we find interesting matter of value under such heads as "Accounts, criticisms of," which deals in some detail with the accounts appearing in a balance-sheet or profit-and-loss account and reminds one of Mr. Pixley's *How to Read*

a *Balance-sheet* and *Organization of an Accountant's Office* dealing with the accounts of an accountant. Similar excellent articles are scattered throughout the book under such headings as "bills" of various kinds; "internal check," "goodwill," "investigations." The article on auditing occupies over seventy pages and, besides discussing the details of an audit, mentions special points in the audits of various enterprises such as banks, builders, building societies, etc. One subsection deals with auditors' certificates, but here the British legal requirements are the chief consideration and there is little discussion of the difficulties which beset the American accountant in this regard.

Reserves, reserve funds and sinking funds are excellently dealt with under the head of "balance-sheet" and also under reserves and reserve funds. The author enters his protest against the indiscriminate uses made of these expressions and insists that fund should be used only when cash or securities are in actual possession. At the same time he regrets that his views are not shared by all competent accountants and, therefore, he cannot lay down the rule that it is incorrect to describe an ordinary reserve as a reserve fund—a regret in which we all share. A suggestion, worthy of serious consideration, is made to the effect that the word "provision" describes more accurately than "reserve" the nature of an account set up for the purpose of keeping certain amounts out of revenue receipts or for making provision for the replacement of some asset, yet none of the pattern balance-sheets given in the dictionary contains any such account.

The present dictionary may be placed, in size, between Pitman's *Dictionary of Bookkeeping* or Dawson's *Compendium* on the one hand and Lisle's *Encyclopædia* on the other. It devotes much less space to illustrative forms and to mathematical formulæ and to abbreviations than does the encyclopædia but in a general way covers the same ground. While it contains little that is new, it does provide a mass of sound statements on general accounting matters, clearly expressed and well arranged. It should find a place in all accounting libraries; it is instructive to the student; useful as a book of reference to any enquirer, and affords a mine of value to anyone desiring to quote high authority on accounting matters, the weight of its authority being increased by the fact that its well-known editor is supported by capable colleagues and, we assume, the book is the result of their combined experience and knowledge.

A somewhat detailed comparison of this work with four or five others of a more or less similar nature proves conclusively that at present there is not in existence any vocabulary of accounting terms such as is now being prepared by the committee on terminology appointed by the American Institute of Accountants.

WALTER MUCKLOW.

ECONOMICS FOR THE ACCOUNTANT, by KEMPER SIMPSON. *D. Appleton & Co.*, New York. 206 pp., cloth.

Economics for the Accountant is a short treatise on economic principles as they apply or, in Doctor Simpson's opinion, should be applied to the

work of an accountant. Starting with the general definition that "economics is the social science that deals with man in his efforts to make a living or to satisfy his wants," he shows that two processes are always involved, consumption and production, consumption being the beginning and the end of economic study, for "it furnishes the incentive for economic endeavor and it constitutes the ultimate purpose of all economic organization." The accountant's work deals principally with production, so it follows that the book is devoted to the principles underlying production costs and the distribution of the producer's profit.

Production factors consist of labor, land (including capital goods), capital, and that intangible and somewhat elusive element called enterprise, management or direction. These factors are represented respectively by laborers, owners of land and capital goods, capitalists and entrepreneurs. All human effort, whether mental or physical, is classed as labor. Land and capital goods are the land, goods, machinery and instruments used by the producer in creating his product. Capital is defined as "postponed claims on consumption goods expressed in terms of money" lent to the producer with which to purchase capital goods. The entrepreneur is the man (or group of men) "who controls its policies because he has legal title to its capital goods and its product." The economic rewards of each class respectively are termed wages, rent, interest and profits.

After some preliminary discussion of the effect upon prices of demand and the medium of exchange, the author proceeds to discuss the main topic of his book, economic *vs.* accounting costs. The elements of raw materials, labor, factory overhead, general and administrative expense, selling expense and depreciation are seen to be economic as well as accounting costs. Further, Doctor Simpson maintains, theoretical (that is, not actually incurred or paid) rent, salaries and interest on investment are not only economic but also accounting costs and should be included by the accountant in production costs. Finally there is left the pure economic profit which goes to the entrepreneur.

It will be observed that the author departs widely from generally accepted accounting practice in his treatment of the above-mentioned theoretical elements, not only in analyzing the total profits into the four categories given, but in requiring three of them to be included in prior production costs. It may also be mentioned that his conception of "production cost," which includes everything except the entrepreneur's profit, bears slight resemblance to the accountant's "cost of production." Likewise his "gross profit" is not the difference between sales and cost of sales but the entrepreneur's profit plus interest on the invested capital.

Three appendices close the book, two being elaborate arguments in favor of the author's views of disputed elements of costs, e.g., interest on investment, and the last giving a list of questions in economics asked in several state C. P. A. examinations, with references to the chapters in the book where answers may be found.

The accountant who reads the book will enjoy the little trip into the rarer atmosphere of economic theory, and if it leads him to a wider study of the science of economics, so much the better for him. The broader the education, the better the accountant. But when he gets back to the

solid ground of practical accounting he will quickly be confronted with some knotty problems to be solved before Doctor Simpson's theory as a whole can be reduced to practice.

W. H. LAWTON.

PROBLEMS IN BUSINESS FINANCE, by EDMOND E. LINCOLN. *A. W. Shaw Company*, Chicago, 1921. 525 pages.

It has been only a few years since the "case system" or the "problem method" of instruction in business was first proposed. The proposer was thought more or less radical at the time, and the idea was not received with any especial enthusiasm. It practically meant, as was stated by a leading business educator, the scrapping of all that had been accomplished during the lifetime of those actively engaged in business education. Yet today the problem method of teaching business is taken for granted, and business schools everywhere are actively engaged in gathering materials and in the preparation of problem books for classroom use. Some of the leading correspondence schools, even, have of late been advertising that their courses are now being taught by the problem method.

Professor Lincoln's book is one of the first "problem books" to appear. The problems have been drawn directly from the financial experiences of many business men and bankers. They represent more than one hundred and twenty-five totally different kinds of business and industry and hundreds of separate concerns.

The first part of the book contains a full outline and a rather complete bibliography "for a general course in business finance dealing primarily with small and medium-sized industrial concerns." This is followed by a brief statement to teachers, students and to general readers, after which the author makes a general survey of the field, points out the distinctions between "trust" finance and "corporation" or business finance and emphasizes the importance of proper purchasing, of adequate working capital, of established credit, etc. Professor Lincoln states that "it is an American commercial trait to overrate the selling end of the business," and he then proceeds to point out the evils of "over-selling," of making special concessions to customers, etc. Successful financing is largely a matter of coöperation—coöperation between banks and business concerns and between numerous business concerns themselves.

The rest of the volume—comprising some 450 pages—is given over to the problems and to accompanying references, which usually give a clue to the solution. Part II of the text takes up the sources of capital, and discusses the numerous problems involved in the raising of fixed and working capital. Some 112 problems compose this part of the volume. Problems of internal financing are next discussed. These problems include the financial aspects of purchasing goods, producing goods, selling goods and administering the earnings. In selling the goods, the author considers sales and price policies, coöperation between the credit and sales departments and the customer, the problem of discounts and of collections and the financial aspects of advertising. We believe the coördination of the various functions of purchasing, manufacturing, selling and financing might

Book Reviews

have received somewhat more attention, for that internal control of departments—sometimes spoken of as budgeting—is as essential to business success as is the external coöperation which Professor Lincoln emphasizes. Fifty-eight problems are included in this section of the text. The remainder of the book furnishes problems on financial involvements, receiverships, reorganizations, promotions, etc., etc. Twenty-one problems furnish material for this section of the book.

A statistical appendix of some forty pages contains much practical and interesting information concerning such things as the number and size of industrial concerns in the United States by five-year periods from 1899 to 1914, the standards for credit granting in various industries, the financial standards in the rubber, automobile and cotton industries, classified expenses and annual turnover of stocks in retail stores, corporation income distributed by industrial groups, etc. A very interesting table of the record of business failures in the United States is also shown.

To the layman it would appear that Professor Lincoln has done exceedingly well a quite difficult and heretofore untried task. The volume is not one which will appeal greatly to the general reader, but to the student of business finance who will read first the general references and will then give intelligent thought to the accompanying problems the book will prove of great benefit and a real inspiration. The book is not without faults, but there is so much more of good that might be said about it that we shall not attempt any adverse criticism of it. It is well printed, and contains an exceedingly full and valuable table of contents. There is no index.

J. HUGH JACKSON.

WALL STREET ACCOUNTING, by FREDERICK S. TODMAN. *The Ronald Press Co.*, New York. 350 pp.

Wall Street Accounting is an enlarged and revised edition of the author's *Brokerage Accounts*, published in 1916. It gives a complete description of accounting methods, books and forms used by the leading brokerage houses in New York and other large cities and, in addition, a very informing analysis of the technique of trading on the stock and commodity exchanges. The change in title from the 1916 edition is well advised, for the book deals with stock and commodity brokerage only, and the old title was therefore somewhat misleading, as the writer, who once searched vainly in it for information on real estate brokerage, can testify.

The auditing of a stockbroker's books calls for the maximum of accurate detailed verification in the minimum of time, and naturally this class of business is chiefly confined to a few large and well-equipped public accounting firms. The public accountant of limited experience and resources who rashly accepts such a contract ventures in where angels fear to tread. If he doubts it, let him read Mr. Todman's book. But whether for informing or for deterrent purposes, the book should be in a public accountant's library.

W. H. LAWTON.

MATHEMATICS OF ACCOUNTING AND FINANCE, by SEYMOUR WALTON and H. A. FINNEY. *Ronald Press Co.*, New York. 274 pages.

"The earlier chapters explain in considerable detail a number of short processes and practical suggestions that may be applied in routine computations of any sort. Particular attention has been given to the matter of adequate checks upon calculations.

"The central portion of the book treats of the special applications of arithmetical principles and short methods to the problems of individual lines of business.

"In the final chapters an attempt has been made to explain, in simple terms, convenient ways of using logarithmic and actuarial methods in the solution of business problems relating to compound interest, investments, annuities, bond discount and premium, effective bond rates, leaseholds and depreciation."

This is a quotation from the preface and recites the subjects treated in *Mathematics of Accounting and Finance*. The book is written throughout in clear and simple terms and with few exceptions the methods of solving the specimen problems are discussed at length so that the reader or student may follow the reasoning leading up to the results and formulas given. The short cuts and suggestions in the earlier chapters seem rather obvious and in reading them over one wonders what the authors meant by "material of advanced nature" referred to elsewhere in the preface. They are indeed so elementary that the public school may reasonably be expected to have prepared the average person for the exercise of his reasoning faculties when confronted with these everyday problems of office and business arithmetic. However, the suggestions themselves are good enough although many more, and more useful ones, could have been given. The central portion deals with a number of special problems that are met in the ordinary office or business routine, as for instance, averaging accounts, liquidation of partnerships, calculation of goodwill, consolidation of foreign-branch accounts with the head office books, etc. None of these topics is treated at all exhaustively but a student of accounting and business methods will find a good deal of useful information in that part of the book. The chapters on logarithms, simple and compound interest, annuities, bond values, etc., present the solutions of the various standard problems very clearly; but here also there is no material improvement upon the treatment in the school texts.

On the whole the merit of the book lies more in the special information which it gives on various subjects than in the exposition of arithmetical or mathematical processes.

A. VAN OSS.

Society of Incorporated Accountants and Auditors

The thirty-seventh annual meeting of the British Society of Incorporated Accountants and Auditors was held in London, May 18th. The report of the council showed that on December 31, 1921, the society's roll contained the names of 3,360 members.

Missouri Society of Certified Public Accountants

At the annual meeting of the Missouri Society of Certified Public Accountants, the following officers were elected: President, E. G. H. Kessler; first vice-president, Page Lawrence; second vice-president, O. M. Cartall; treasurer, F. A. Wright; secretary, E. W. Gottenstrater.

Current Literature

Compiled in the Library of the American Institute of Accountants

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J. W. McCullough & Co. announce the removal of their offices to 708-710 Union National Bank building, Houston, Texas.

Leon Brummer and Sanford Becker announce the formation of a partnership, practising under the firm name of Leon Brummer & Becker, with offices at 53 Park place, New York.

The JOURNAL *of* ACCOUNTANCY

Official Organ of the AMERICAN INSTITUTE *of* ACCOUNTANTS

Vol. 34

SEPTEMBER, 1922

No. 3

New York Stock Exchange Questionnaire

A SUGGESTED PROGRAMME OF WORK TO BE PERFORMED AND THE ARRANGEMENT OF SCHEDULES TO BE SUBMITTED IN ANSWERING THE QUESTIONNAIRE ISSUED BY THE NEW YORK STOCK EXCHANGE TO ITS MEMBERS.

By EUGENE V. PORTWAY

The Committee on Business Conduct of the New York Stock Exchange has recently issued a questionnaire to registered member firms, requiring certain information as to their financial status at a specific date.

This questionnaire will undoubtedly produce beneficial results, as, in the first place, the figures when completed will bring out features of the business that may not have received special attention before; and, secondly, it will place in the hands of the committee financial statements of its members from which can be ascertained their solvency and the policy pursued in conducting their business for customers.

In issuing the questionnaire there is no doubt that the object of the Stock Exchange is to protect the investing public, and where necessary to give advice to members who, from lack of attention, may be conducting their business along lines that might not reflect sound judgment.

The questions are seven in number and the information required is clearly set forth in the questionnaire. From the answers to these questions it will be possible to prepare a statement of assets and liabilities of the firm, and by segregating the security balances, debits and credits, the two sides should balance (see schedules "A" and "B," page 162).

Schedule "A"

BALANCE-SHEET

PREPARED FROM ANSWERS TO QUESTIONNAIRE

<i>Debits</i>		<i>Credits</i>	
QUESTION 1.	TOTAL BANK BALANCES, Contributions to clearing funds and margin deposits.....	QUESTION 2.	TOTAL MONEY BORROWED.....
2.	STOCKS BORROWED		STOCKS LOANED
3.	FAILED TO DELIVER.....	3.	FAILED TO RECEIVE.....
3.	NIL	4.	NIL
4.	CUSTOMERS' ACCOUNTS, Stock dr. balances, secured, partly secured, unsecured, grain dr. balances.....		CUSTOMERS' ACCOUNTS, Stock cr. balances against short sales free balances, grain cr. balances
5.	PARTNERS' INDIVIDUAL ACCOUNTS, Firm investment and trading accounts, underwriting and syndicate participation accounts, exchange seats, furniture and fixtures, other fixed assets.....	5.	CAPITAL ACCOUNTS
		6.	PROFIT-AND-LOSS AND SURPLUS
		7.	OTHER CREDIT BALANCES.....

Schedule "B"

SUMMARY OF SECURITIES

		<i>Debits</i>		<i>Credits</i>	
CUSTOMERS' ACCOUNTS.....	"Long" \$			CUSTOMERS' ACCOUNTS.....	"Short" \$
PARTNERS' SECURITIES.....				SECURITIES IN BOX AND TRANSFER.....	
ERROR ACCOUNT.....	"Long"			IN BANK LOANS.....	
JOINT ACCOUNTS.....	"Long"			JOINT ACCOUNTS.....	"Short"
INVESTMENT DEPARTMENT.....	"Long"			INVESTMENT DEPARTMENT.....	"Short"
STOCKS BORROWED.....				STOCKS LOANED.....	
FAILED TO DELIVER.....				FAILED TO RECEIVE.....	
CONTRACTS—Delayed delivery.....	"Long"			CONTRACTS—Delayed delivery.....	"Short"

NOTE:—If the securities in these accounts are uniformly extended at market price, at any date, the two sides should balance.

If the security items do not balance, it may be due to the following reasons:

That the prices of securities in "loaned" and "borrowed" are not identical with market; or that the prices used in valuing securities in box, transfer, loans, etc., are different from those used in valuing securities in customers' accounts; and lastly, but not least, there may be a discrepancy on the books not known to the firm.

The answers to Nos. 1, 5, 6 and 7 of the questionnaire can be readily answered by using the ledger balances in the various accounts, but particular care and attention must be observed in preparing the answers to questions Nos. 2, 3 and 4. The object of this paper is to provide a programme which may be helpful to accountants who are called in to render professional services to Stock Exchange firms.

It might be as well to emphasize at this point that the prices used in valuing securities must be uniform for box, transfer, loans, etc., and customers' accounts; and the prices used must be the "market closing" at the date of the questionnaire.

As soon as the books are finally closed for the period and the trial balances taken off, a balance-sheet should be prepared therefrom and the figures should agree with those used for the questionnaire. Where there is more than one office of the firm and where books of accounts are kept at these branch offices it will be necessary for each office to prepare its own answers. These branch-office figures must be consolidated with the main-office figures and it is at this point that the advantage of preparing balance-sheets for each office is invaluable. (See schedules "A" and "B.")

In consolidating the figures, all inter-office accounts and controls must be eliminated, and items in transit must be taken up.

Particular attention should be given to the arrangement of the schedules and working papers built up to provide the final figures to the questions. These should be indexed to the questionnaire or balance-sheet, so that if further details are required or an audit is called for, the schedules will properly support the information returned.

For general guidance, a set of questions and answers in dummy form is inserted in this programme. These forms have been drawn up to try to meet the requirements of firms transacting a

general stock and bond business. They can, of course, be amplified or modified to suit the nature of the accounts. Each question should be answered on a separate sheet so as to facilitate the analysis of the figures by the Stock Exchange.

QUESTION 1. *Total bank balances.*

These figures should comprise:

The bank balances as shown by the bank statements less outstanding cheques, together with the petty cash on hand, cheques on hand but not deposited and any special free deposits.

Deposits made by the firm with stock, cotton, coffee, produce, clearing corporations.

Margin deposits on account of open contracts on cotton, coffee, sugar, etc., stating the name of the bank with which the deposits are made.

It is the practice of some firms to draw cheques for all "failed to receive" items on the clearance day, and these cheques are not issued until the securities are actually received, which, in some cases, may be several days or even weeks later. This method cleans up the "failed to receive" account each day, thus reducing the actual cash balance. In order to show the true cash balance at the date of the questionnaire the total of these cheques should be added to the cash balance and the amount shown as "failed to receive" on the liability side of the statement.

QUESTION 2. *Total money borrowed and total value of collateral.*

The total money borrowed from banks can be obtained from the ledger balance and this figure should agree with the sum total of the loan sheets. It will be necessary to extend each item in the loans at market to ascertain the total value of collateral, as the prices used for loan purposes may not agree with market at the date of the questionnaire.

The best method for preparing working schedules for valuing the securities in loans will largely depend upon the internal system in vogue.

If only loan sheets are used to record the securities hypothecated it will be necessary to extend each item on the loan sheet or to summarize the securities, but where a "loan finder" is in use and the securities are arranged alphabetically the work will be simplified.

New York Stock Exchange Questionnaire

The securities should be listed in advance on schedules arranged alphabetically and will run thus :

Security in loans	No. of shares	Market value	Total value of collateral
U. S. Liberty 1st 4's:			
City bank	\$10,000.00	\$.....	\$.....
Chase bank	10,000.00	.....	.....
Guaranty	10,000.00	.....	.....
Seaboard	10,000.00	.....	.....
	<u>\$40,000.00</u>	<u>\$ par</u>	<u>\$40,000.00</u>

In valuing securities, fractions should be entirely eliminated, as this will facilitate the work and prevent irregularity in pricing.

The sum total of the extensions on this schedule will, of course, represent the total market value of the securities deposited with the banks as collateral against loans.

An interesting comparison can be made between the actual value of securities in loans and the values of the securities required in loans, and the market value of securities in loans against actual bank loans, viz. :

Market value of securities in loans.....	\$
Value of securities as used in loans.....	\$
Excess margin as required by banks.....	\$
Market value of securities in loans.....	\$
Total loans	\$
Actual margin with banks.....	\$

Another feature can be brought out by segregating the loans and finding the percentage of the different kinds of securities used in such loans as :

Description	Amount of loan	Value of security	Percentage
Bonds	\$	\$	%
All industrials	\$	\$	%
Rails and industrials.....	\$	\$	%
	<u>\$</u>	<u>\$</u>	<u>100%</u>

These comparisons will, no doubt, be of considerable interest to partners not familiar with this feature of their business.

The securities in the following accounts should be verified by letter with other houses at the date of the questionnaire and the

totals should agree with the balances as shown in the ledger accounts:

Stocks borrowed	Dr.
Stocks loaned	Cr.
Failed to deliver.....	Dr.
Failed to receive.....	Cr.

QUESTION 3. *Market value of negotiable securities in box and in transfer.*

At the close of business at the date of the questionnaire the securities in the box should be counted, listed alphabetically, priced, extended and classified as follows:

BOX COUNT AND VALUATION.

Description of security	Market price	Listed on N. Y. Stock Exchange		Not listed on N. Y. Stock Exchange	
		Market Value over \$5 per share	Market Value under \$5 per share	Market value over \$5 per share	Market value under \$5 per share

The totals as shown in the various columns will represent, in the aggregate, the total value of the securities in the box. It would be as well when listing the securities to keep bonds separate from stocks, when the following recapitulation can be made, in order to ascertain the different classes of securities in the possession of the firm.

SUMMARY.

Stocks listed on New York Stock Exchange.....	\$
Stocks not listed on N. Y. Stock Exchange.....	\$
Bonds listed on N. Y. Stock Exchange.....	\$
Bonds not listed on N. Y. Stock Exchange.....	\$
Total	\$

It must be observed that the value of securities in safe keeping and the value of any securities carried as "long," if paid for in full by customers, must not be included in the above figures. The value of the securities in transfer should be worked out in the same manner as the securities in the box. These items will, of course, be obtained from the transfer register.

New York Stock Exchange Questionnaire

QUESTION 4. *Total ledger debit balances in customers' accounts and the value of securities deposited as collateral against same.*

These are to be classified as follows:

- I. Secured
- II. Partly secured
- III. Unsecured

A list of the customers, alphabetically arranged, should be prepared in advance and the working schedule should be set up as follows:

Name of Customer	Balances as shown by ledger	DEBITS Securities long			CREDITS	
	Dr.	Cr.	Secured	Partly Secured	Unsecured	Short
			Market value of security	Market value of security		Free credit balances
Total	\$		\$	\$	\$	\$

These lists having been prepared showing the names of the customers, the debit and credit balances can be inserted as soon as the trial balances have been taken off. These schedules should then be reconciled with the trial balances.

The most important feature of this question is the valuation of the securities in the accounts; the method of performing this work depends largely upon the system in vogue and size of the accounts. As this work must be completed within a limited time, it is advisable to be as expeditious as possible. The following method is suggested:

It is assumed that margin cards or records are kept for all accounts on the books, and, as these cards or records will be complete at the close of business on the date of the questionnaire, whereas there may be a delay in posting the customers' ledger accounts and taking off the trial balances, working to the margins has a distinct advantage.

As the Stock Exchange requests that all schedules used in building up the figures shall be filed away for future reference, the prices and extensions on the customers' accounts must be preserved. It is therefore advisable either to file the margin cards or to list the securities in each of the customers' accounts on separate schedules. The pricing and extending can then be made without hindrance to the regular margin work.

As soon as the trial balances are taken off, the balances as shown by the margins and the collateral deposited with the firm should be compared with the ledger accounts. If, however, the ledger postings and trial balances are not delayed it would be preferable to list the balances and securities direct therefrom.

An analysis of each debit account will disclose whether it is fully secured, partly secured or unsecured; and on the credit side, if against short sales or a free-credit balance.

A summary of these debit accounts should then be prepared as follows:

Accounts	Total debit balances	Value of collateral	Percentage of equity
Secured	\$	\$	%
Partly secured	\$	\$	%
Unsecured	\$	\$	
	\$	\$	

The difference between the total debit balances and the total value of securities in the customers' accounts will, of course, represent the customer's equity and the firm's protection.

In stating the partly secured and unsecured account it is advisable to give a brief explanation of the balances in the larger accounts, stating the value of the securities and whether or not it is protected by other collateral such as life insurance policies, notes, etc. By giving information of this kind, one may obviate the necessity of further inquiry.

The total value of the securities against such accounts as clients' cash investment accounts (securities charged but not yet delivered) and contracts on account of delayed delivery trades should equal the ledger balances. There is an advantage in showing these items separately, as by doing so the percentage of equity in the regular customers' accounts will not be affected.

Total ledger credit balances in customers' accounts:

The working sheet of customers' accounts will show the credit balances against short sales and free-credit balances and the following schedules should be prepared therefrom:

CREDIT BALANCES AGAINST SHORT SALES				
Accounts	Credit Balances	Value of securities short at market	Number of Shares	Margin require- ments
Total				

New York Stock Exchange Questionnaire

The credit balances should exceed the value of the securities short by the marginal requirement, the customary margin being based upon the number of shares rather than the security value. If, however, these accounts are protected by excess margin in the customers' long accounts a statement to this effect should be made.

The option accounts, grain, cotton, etc., should be carefully analyzed and the following information set forth:

1. Customer's accounts :—Cr. balances	Equity or deficit	Total balance at market
2. Customer's accounts :—Dr. balances	Equity or deficit	Total balance at market
3. Customers free-credit balances: These should be added to the free-stock balances.....		\$
4. Customers' debit balances: No commodities		\$

As the debit balances in item No. 4 may be made up of amounts owed by street brokers and are good and collectible, a statement to this effect should be made.

Free-credit balances will consist of the total of items shown in customers' stock account working schedule, together with free-credit balances in the option accounts.

In listing the free-credit balances care should be used not to include any credit balances which are in reality an offset or protection against debit-margin accounts. Credit balances of this nature should be deducted from the total customers' debit balances. Under this heading should be set forth balances in syndicate accounts, that is to say, margin deposited by participants against syndicate operations.

QUESTION 5. Partners' accounts including capital accounts.

Should any of the partners have open accounts on the books other than their capital accounts, a full explanation of the nature of them should be given, stating the value of collateral, if any.

Under subheading "firm's investments" and "trading accounts" the following items should appear:

Account	Balances		Value of Securities
	Dr.	Cr.	
1. Error account:			
Securities, marked to market.....			
2. Bond trading accounts:			
Securities long, marked to market.....			
Securities short, marked to market.....			
3. Joint accounts with other firms:			
Securities long, marked to market.....			
Securities short, marked to market.....			

The securities in these accounts should equal in value the debit or credit balances shown by the books.

The capital accounts of the partners should be set forth in total and a statement should be made as to whether the amounts consist of cash or cash and securities owned by the individual partners. Securities in these accounts should be valued at market at the date of the questionnaire.

Stock and other exchange seats should be stated in total and at cost.

Office furniture and fixtures should be stated at cost, less depreciation if a reserve is set up on the books.

Other fixed assets should be listed and the nature of the investment should be clearly set forth.

QUESTION 6. *Profit-and-loss accounts.*

The balances in the profit-and-loss accounts may be listed credits and debits, but, if desired, a net figure can be given.

QUESTION 7. *Other accounts.*

Under this heading all other accounts appearing on the books should be listed—debits and credits—stating briefly the nature of them.

ANSWERS TO QUESTIONS SET UP IN SCHEDULE FORM

QUESTION 1. *Bank balances, etc.*

1. Cash in banks and on hand..... \$
2. Contributions to clearing funds:
 - Stock Exchange corporation..... \$
 - Cotton Ex. Clearing corporation..... \$
 - Coffee Ex. Clearing corporation..... \$
 - Produce Exchange \$
 - Etc. \$

\$

New York Stock Exchange Questionnaire

3. Margin deposits:

New York Coffee and Sugar Clearing Ass'n deposited with bank..... \$

New York Cotton Exchange Clearing Ass'n deposited with bank..... \$
 Etc. \$

QUESTION 2. *Total money borrowed and total value of collateral.*

1. Total money borrowed:

New York \$
 Branch offices \$
 _____ \$
 Total value of collateral..... \$
 _____ \$

2. Ledger balances in the following accounts:

Stocks borrowed \$
 Stocks loaned \$
 Failed to deliver \$
 Failed to receive..... \$

NOTE.—State whether any accounts are carried for firm by other banking and brokerage houses.

QUESTION 3. *Market value of negotiable securities in box and transfer books.*

1. Listed on New York Stock Exchange:

Market value over \$5 per share..... \$
 Market value under \$5 per share..... \$
 _____ \$
 _____ \$

2. Not listed on New York Stock Exchange:

Market value over \$5 per share..... \$
 Market value under \$5 per share..... \$
 _____ \$
 _____ \$

NOTE.—The above figures must not include any securities in safe keeping nor the value of any securities carried as "long" if paid for in full by customers.

QUESTION 4. Customers' accounts.

A. Total debit balances in customers' accounts:

	Amount	Value of collateral
1. Secured:		
Customers' and wire accounts.....	\$	\$
2. Partly secured:		
Customers' accounts	\$	\$
These accounts are protected as explained below:		
	Amount	Collateral
1	\$	\$
2		
3		
4		
		Give brief explanation of partly-secured accounts and state whether amounts will be collected eventually.
3. Unsecured	\$	
Clients' investment accounts.....	\$	\$
Contracts:		
Delayed delivery	\$	\$

B. Total credit balances and option accounts

	Amount	Value of securities short
1. Customers' and wire accounts.....	\$	\$
Contracts:		
Delayed delivery	\$	\$
2. Customers' credits and debits on open contracts in grain, cotton and other commodities:		
		Total balance at market
Customers' accounts	Cr. balances \$	Equity \$
	Dr. balances	Deficit \$
Customers' accounts	\$	\$
Debit balances		
No commodities	\$	
(State here nature of debits and whether collectible.)		
3. Free-credit balances	\$	\$
4. Syndicate account	\$	\$

New York Stock Exchange Questionnaire

QUESTION 5. *Partners' accounts; including capital accounts.*

	Debit balance	Value of collateral
A. Partners' individual accounts other than capital accounts.....	\$	\$
		Value of securities
B. Firm investments and trading accounts:	balance	
1. Error account		
Securities marked to market.....	\$	\$
2. Bond trading department		
Securities long marked to market	\$	\$
Securities short marked to market	\$	\$
3. Joint accounts with other firms		
Securities long marked to market	\$	\$
Securities short marked to market	\$	\$
C. Capital accounts		
Stock and other exchange seats—at cost.....		\$
Office furniture and fixtures.....		\$

QUESTION 6. *Profit-and-loss accounts.*

QUESTION 7. *Other accounts.*

Debits:	\$
List here all other debit accounts which have not been included in one of the answers to the questionnaire.	
	\$
	\$
Credits:	\$
List here all other credit items which have not been included in one of the answers to the questionnaire.	
	\$
	\$

IN CONCLUSION

The preparation of the foregoing figures is, in effect, an internal audit of the assets and liabilities of the firm at a specific date, and a close study of them will reveal interesting and valuable information.

It would be desirable, if possible, to calculate the customers' equities monthly, but the volume of work involved renders it impracticable—and this feature can be taken care of by an efficient margin system.

In some firms which have branch offices, the percentage of customers' equities is shown on the monthly trial balances, which enables the main office to see that the branch-office customers' accounts are properly margined.

The questionnaire will no doubt do for brokerage firms what the income tax has done for the commercial world: it will bring about a closer and better knowledge of financial business as it relates to stock-brokerage business and improved accounting.

Twenty-Five Years of Accountancy

By EDWARD L. SUFFERN

The association of words in the title is due to the fact that this year the twenty-fifth anniversary of the organization of the New York State Society of Certified Public Accountants was held and, as was natural, thought reverted to the accounting conditions prevailing at and the changes since that beginning date.

We will have to go much further back, however, to reach what was really the beginning of the practice of public accounting in our own country and perhaps no one can say with exactness just when that was. Certain it is that more than forty years ago there were some men in large cities who were called public accountants and who audited or "checked up" books with the object mainly of discovering or safeguarding against irregularities rather than for constructive work. Somewhat later the foreign shareholders and bondholders of a number of large enterprises, mainly but not exclusively railways, desired that the accounts should be audited after the fashion of home companies and sent out auditors from England to perform such service. This practice led to the opening of offices here and thus were established a number of the firms which have become so influential in the accounting world. To most of these early comers and to their successors and associates accountancy owes an acknowledged debt. They brought with them and developed in their staffs a large learning in the principles, procedure and traditions of accounting and have stamped their impress upon its history here. Coinciding with and closely following them, American accountants became more numerous, and in the larger cities a choice of accountants was offered the prospective clients who could find well-qualified men to render the service desired. It is true that such men had acquired their knowledge not in schools but through experience under actual working conditions, which has been always an excellent form of education. There is something to be said in favor of Mr. Squeer's system, under which as soon as a boy learned how to spell "winder" he was sent to wash it.

In 1887 there were in New York sufficient numbers of practising accountants to justify calling them together and organizing

a society, and the American Association of Public Accountants was incorporated. It was intended to be and was from the beginning a national organization, although naturally most of its members were residents of New York, and it was a start toward bringing together men of like calling to discuss matters of common interest and through acquaintance to create mutual confidence and respect. Perhaps this latter object was not so distinctly conceived, but it was enfolded in the other.

During the succeeding ten years the growth of public accounting was marked. Corporation accounts were being more generally audited, special financial examinations were being made and there was a wider spread of knowledge in the minds of the public that there existed a class of men whose services were available when required. This enlightenment, however, was very, very slow and far from general—as it is still, for that matter. The common idea was that “books” were things you wrote figures in. And, if the figures were correct, why was one man any better qualified than any other? So no review of figures was necessary unless someone had stolen something.

As the years progressed a number of New York accountants became greatly interested in securing the enactment of a law which should create a definite status and title for such public accountants as should be able to comply with the requirements which the law should prescribe. The effort was persistently pursued, and in December, 1896, the first law defining the title and qualifications of certified public accountants was enacted. This gave encouragement to accountants in other states to obtain similar legislation and, with various modifications, enactments were obtained in rapid succession in Pennsylvania, Illinois, Missouri and other states, until in the course of time the whole quota became filled.

One common feature of these laws provided a waiver clause, i. e., that a certain time limit was prescribed in which applicants for certificates who should produce evidence that they possessed the required qualifications might be granted such certificates without examination.

Shortly after the passage of the New York law some of the grantees met and organized (on March 30, 1897) the New York State Society of Certified Public Accountants, eighteen signing the roll and becoming charter members. Charles Waldo Haskins

was elected president, a position he continued to hold until his death in January, 1903.

In some states quite active and efficient societies antedated the enactments, but as soon as the laws were passed societies were organized with restrictive memberships and became, in most cases, the centers of co-operative effort in establishing and advocating standards of practice. In all of them (presumably) emphasis was placed upon maintaining and elevating these standards, and in the larger societies there rapidly developed a spirit of mutual co-operation and confidence dispelling suspicion and distrust.

This movement came none too soon. The times demanded that there should be some classification of accountants which should distinguish (at least theoretically) between those who were supposed to be competent and those who were not. For several years the country had suffered great business depression. Among other causes the "free silver" question had demonstrated its economic injury and had been the paramount issue in the presidential campaign of 1896. With the election of McKinley this menace was believed to be removed, and with his inauguration in March, 1897, the country took courage and became hopeful. A widespread revival of business ensued, for which there were some substantial reasons as well as a general optimism. In the fall of that year the writer well remembers seeing in a small Western town some rather hilarious farmers showing from their wagons on Saturday afternoon rolls of bills and shouting: "A dollar a bushel for our wheat."

This general business recovery manifested itself in some very striking ways. For years before there had been combinations and mergers of separate enterprises into larger units, and this became a popular financial pastime. To bring together a number of separate concerns in any industry (it did not seem to matter what), consolidate them into one corporation, capitalize them for whatever sum it was thought the public might be induced to pay for the larger part of the preferred shares—while keeping as much of both kinds of stock as possible for the promoters—this seemed to constitute the formula for successful flotation. If there were added to the formula elements of conscience and ability, so much the better were the chances of survival, and those which did have more than a brief existence owed their good fortune to the increased percentage of these elements.

It was a wild time, speaking generally, and in nothing more wild than in the utter disregard of the fundamental principles which we have come to regard as controlling. Properties acquired for cash and capital stock issued to vendors (and promoters) on bases of valuation calculated to include prospective earnings were all too common transactions. Figures, not facts, were what were wanted, and accountants could be found whose ideas as to the distinction between them were very nebulous.

Because of this great impetus to business the services of accountants were more largely demanded than before, and the supply of alleged accountants became noticeable. Those firms which were already well established in most of the large cities and were ably serving important and distributed clientages were seeking trained assistants, of whom there were comparatively few, and this led to the conviction that one of the first efforts of the organized societies should be toward developing systematic instruction and training in accountancy for men who wished to fit themselves for a career. Such training previously had been in offices and elementary schools, but it was evident that more thorough and advanced work was necessary. Therefore, we find that early in the history of the New York society steps were taken to secure the co-operation of some educational institution which would establish a course in accountancy to meet the future needs for trained assistants. The institutions were skeptical as to the feasibility or advisability of such a step, but at length, heeding the urgings of the committee making such effort, the New York University instituted, in 1901, the course and established the school of commerce, finance and accounts, with a registry of sixty-three students, appointing as its dean Charles Waldo Haskins, whose untiring energy and promise of support had served such good purpose. Thus was established the first distinctive school of accounting in the country, an example which was followed shortly after by the Wharton school in Philadelphia in 1902 and in fairly rapid succession by other institutions of learning.

As one looks back at those beginnings when the first classes were so small and compares them with the scores of undergraduate and graduate schools today with their individual registries of many thousands of students, one is amazed at the progress made and the recognized place accountancy occupies in the scheme

of education. In addition to the institutional education, there are the great schools under more personal and private direction which are doing a work worthy of honor. This does not apply, however, to all such endeavors, some of which advance such claims for patronage through specious advertising and solicitation that it is a question whether or not they constitute a menace to serious accounting education. Such advertising as the "demand is greater than the supply" is to be deplored. One is tempted to suggest as a slogan to such advertisers, *Accountancy before breakfast—ten-thousand-dollar position before lunch.*

To establish the first courses demanded pioneer work. In a general way the separate subjects to be studied were known, but the text, the plan, the procedure, had to be determined, prepared and revised. Necessarily the earlier efforts were of an experimental character both for the teacher and the student, but gradually a systematic, constructive course of study was evolved which in its main characteristics is common to all institutions. To these simple beginnings the amplified comprehensive curricula of today, including economics, banking and related subjects, bear the same resemblance only that the full flower bears to the implanted seed—but the seed contains the germ and the principle of life.

To give honor to all those men through whose unselfish and intelligent efforts this development has been possible would make this record a roster of the well deserving; to omit any would be invidious; but to those men accountancy as represented by its practitioners owes gratitude and admiration.

The need of a technical literature in those early years was conspicuous. Very little had been produced in this country and we were dependent upon the English works, which while valuable indeed were not wholly adaptable to our conditions; but these needs did not long continue unsupplied. Almost immediately the most essential books were published, precursors of the immense number covering all subjects relating to accountancy, finance, commerce, economics, production and law which fill our shelves. The accountant of today, no matter whether he be a student or has been practising forty years, has at his disposal and use a wealth of knowledge beyond the capacity of any one man to absorb; therefore, his reading and study should be selective. The *Accountants' Index*, compiled and published by the American

Institute of Accountants, has nearly 1,600 pages of listings of authors, subjects and publications, and this gives us some idea of the product of these years. Every accountant should have a copy of this *Index*; to be without it is to forego a most useful implement.

As the number of societies increased it became apparent that, while each might have some individual problem, there were larger ones common to all. If it were a good thing to dispel jealousy among the members of one society, it would be equally well to do so between the societies. Intelligence and conscientiousness were attributes confined to no one place; high character, technical attainments and earnest purpose knew no geographical limits, so it might be worth while to combine effort toward a common end.

This somewhat vaguely perceived object took shape and plan in the mind of one man, George Wilkinson, now of Philadelphia, who had a widely distributed professional acquaintance. He saw and he acted. Like Cecil Rhodes, he had a "continental mind," and, with untiring energy, he formulated a plan to bring together all the societies in an organized association or federation for the general welfare of the members and of the practice of accountancy. His plan met with favor; delegates representing a number of societies met in Washington in October, 1902, in response to a call issued at the instance of the Illinois Association of Public Accountants; an organization was effected, and the Federation of Societies of Public Accountants in the United States was launched. Mr. Haskins was elected president and Mr. Wilkinson secretary. Committees were appointed with due deference to the susceptibilities of the societies represented and a channel was opened for mutual intercourse and consultation. This organization accomplished much in engendering a co-operative spirit and respect and friendship among those brought together.

The American Association of Public Accountants was organized in 1887, as has been said, and had a few members resident in other cities, but did not have a constituency representative of the country at large, as did the federation, and consequently could not undertake the co-ordinated work which the latter could do. So manifest did it become that the federation had a place to fill and a function to perform that in 1905 the two organizations came together under the title of the older society and under the

presidency of John R. Loomis, retaining for the most part the plan of the federation and the representation of the member societies through delegates elected in accordance with the provisions of the newly-adopted constitution. With the growth of the association, its stimulating influence, the excellent work of its committees and the progress made in the reputation of its membership, accountants are familiar. Its main impediment to greater advancement, however, was the complication of its organization. Its membership (after the merger of the two constituent bodies) was confined to members of state societies; it could exercise very little discipline (if any) over its members except through the societies, and the relation of a member to the association was not that of an individual but as a member acting through his society only. Therefore, in September, 1916, the organization was again reconstructed and became the American Institute of Accountants, with its much more flexible and effective structure in its immediate relations to its members. All members in good standing in the association became *ipso facto* members of the institute, which thenceforward regarded each as such irrespective of his society affiliations.

It was fortunate that the change took place when it did, for in the spring following, when we entered the war, there was provided a means through which the services of accountants were made immediately available to the government as could not have been done otherwise.

Since then, while the growth in members has not been particularly rapid, there has been a steady gain in the public estimation of the members, a continually increasing spirit of co-operation among them and a greater recognition of the advantages membership affords. Perhaps the best exemplification of this is the bureau of information conducted by the institute, which provides for every member (and others, for that matter) an opportunity to obtain an opinion on any problem which may arise in his practice. Through an inquiry to the bureau he will receive the opinion of others who, having considered the same conditions, have reached satisfactory conclusions. This is a great proof of the disposition which the members have to share with others the benefit of their own research and experience.

All that has gone before relates to what may be called the subjective development of accountancy, the increasing enlighten-

ment of the accountant, the means for such enlightenment, the encouragement toward higher ethical standards of practice and relations with his fellows. Not less important nor less demonstrable is the change in the objective relations to and attitude of the clients for whom services are rendered.

One of the most trying and discouraging features of these relations years ago was the marked indifference (still speaking generally) of the client toward matters which the accountant developed through his work and which to him seemed worthy of serious consideration. All too often the client's attitude might be reflected by a remark, "Tell me how much I have made; never mind the details." The final result was desired; the factors making up such result were ignored. The elaborate analysis which today is common with its instructive demonstrations was considered superfluous.

This change is due to at least two influential causes: first, the larger knowledge of economic principles, the closer scrutiny of conditions on the part of investors, the regulatory governmental supervision of some classes of affairs and the requirements of detailed tax returns, and, second, the greater confidence of the client in the accountant's knowledge, intelligence and disinterested effort.

When one considers the elaborate study and revelations embodied in cost accounts, for example, or the carefully segregated exhibits of causes and effects as shown in reports of today, one who has the background of remembrance can appreciate the happy changes. All this augurs well for the future, for the maintenance and further development of such relations is the accountant's hope and promise. That some accountants have been found unworthy of confidence is undeniable and deplorable, but not unexpected. When one is found to be such it is well to have it known for the benefit of all others and for such discipline as the case may warrant should the offender be a member of any society or of the institute. Furthermore, unjust and extortionate fees should be discountenanced by all reputable practitioners. The standards of the vast majority are high, and they should be maintained.

Purposes and Limitations of a Balance-sheet Audit

By GEORGE B. BUIST

Briefly stated the object of a balance-sheet audit is to verify by satisfactory evidence the existence, possession and ownership of all assets and the values at which they are shown in the balance-sheet and to ensure the disclosure thereon of all liabilities—all as at a particular moment of time. The basis for such verification is found in the books of account, subsidiary records and collateral and even external sources of information which circumstances may suggest and an effective audit demand.

Thus, it is not sufficient that all assets appearing on the balance-sheet be on hand or in proper custody or under proper control, but it must be definitely ascertained whether other assets not shown on the balance-sheet and not available for verification should be so available, and, as to liabilities, that the liabilities as shown are actual obligations, that they comprise all the obligations and have all been properly contracted. The outstanding capital stock, surplus and undivided profits in the case of corporations or investment accounts of a co-partnership or individual business representing the net worth are determined both as a result of and concurrently with the verification of the assets and liabilities, and are also susceptible to verification in themselves. A certificate by the auditor that the balance-sheet has been audited by him and sets forth the true financial condition of the concern follows, and a report, informative and explanatory of the balance-sheet, usually accompanies it. No certification as to profits is involved.

It is not intended, in this paper, to discuss balance-sheet audit procedure except as it may be affected by the purposes for which the audit is undertaken or by the limitations imposed. Textbooks with which we are all familiar furnish us, in a greater or less degree, with the pro-forma procedure appropriate to the audit of a balance-sheet; but experience brings the inevitable conclusion that the requirements of each particular case call for more or less deviation from stereotyped formulæ and demand the exercise of individual judgment, initiative, tact and courage on the part of the auditor who would maintain a high professional standard, sat-

isfy his own conscience and retain the respect and confidence of his client.

What, then, must be our guide in the use of such skill as we possess in auditing a balance-sheet, the work on which is inextricably bound up with the purposes for which the audit is made and the limitations which may restrict it? The purposes of a balance-sheet audit are numerous, but it will perhaps suffice to mention the following as being those usually behind the undertaking of such work.

1. To secure credit ;
2. To furnish a certified balance-sheet to prospective purchasers of stock ;
3. For the information and assurance of stockholders, directors and partners ;
4. To furnish a basis for merger or other reorganization ;
5. In the termination and settlement of a co-partnership ;
6. In the purchase or sale of a business ;
7. In bankruptcy or insolvency as a basis for the construction of a statement of affairs.

Balance-sheet audits are called for both as of a current date and as of a date long past, as in the case of bankruptcy, where a statement showing an insolvent condition long prior to the date of petition is required.

A natural question arises at this point, namely, to what extent the auditor's duties are affected by the purpose for which the audit of the balance-sheet is undertaken, and to what extent the auditor himself may be influenced by such purpose.

The purpose of the audit is of course conveyed to the auditor by the client in his instructions. If it is not, the auditor should request information on this point. Lack of knowledge as to the purpose of an audit can only deprive the client of intelligent co-operation on the part of the auditor. Instances are not unknown in which certain purposes have been alleged by the client and the real object in seeking the auditor's services concealed. Alertness on the part of the auditor and care in the presentation of the results of his work will generally defeat any ulterior motive in such cases, and the client usually loses rather than gains by withholding his full confidence from the auditor he employs.

In considering the auditor's duties in the audit of a balance-sheet as affected by its purpose and limitations one's mind not un-

naturally turns to the various oft-quoted judicial definitions with which we have been regaled under the subject of the auditor's duties and responsibilities.

We are told that "he (the auditor) must be honest; that is, he must not certify what he does not believe to be true." "He must exercise all reasonable care, skill and diligence in ascertaining that the balance-sheet correctly reflects the true financial condition." "It is no part of his duty to take stock." "He is not called on to seek for knowledge outside the company or to communicate with customers or creditors." "He is not an insurer against fraud or error." "He must do more than ascertain the mere arithmetical accuracy of the accounts." "He must examine the books, but he does not discharge his duty by doing this without enquiry and without taking any trouble to see that the books themselves show the company's true position; he must take reasonable care to ascertain that they do so." "What is reasonable care in any particular case must depend on the circumstances of that case."

It is not difficult to discover from the foregoing excerpts the legal conception of the limitations which an auditor himself may place on his work in the audit of a balance-sheet. Surely under these definitions no undue hardship nor unreasonable onus handicaps the competent and conscientious auditor. On the other hand, the moral conception of the auditor's duties may well add much to what has been established from the bench. In instances where limitations are imposed by the client, there may not be and often there is not any relation to the purpose of the audit. On the other hand the client's instructions might call for work in excess of the bare requirements of the auditor's duties as judicially defined, and, if accepted, the auditor must faithfully perform such work.

Limitations imposed by the client cannot always be observed. They may, from their nature, prevent the attainment of the very purpose for which the audit is undertaken, or, as in the illustrative case referred to later, they may in themselves present a moral barrier. On the other hand, the limitations imposed by the judgment of the auditor himself, based on his individual recognition of moral and legal responsibility, are affected by the purpose of the audit, the circumstances peculiar to the individual case and the instructions of the client.

From the brief statement, at the outset of this paper, of the object of a balance-sheet audit, it will be readily apparent that limitations to a degree which impairs the efficacy of the verifications called for removes the audit from the scope of our subject. The audit cannot be deemed a balance-sheet audit—it is a partial audit.

A plea for the time-honored institution, the audit report, may not be out of place in the light of the present tendency to eliminate the report or at least abbreviate it to almost the vanishing point.

If the client is content with the assurance of the auditor's certificate, it might be urged that no report is necessary; but if he is, can the auditor in justice to himself dispense with the means offered him for confirming his instructions, placing himself on record as to what limitations have governed his work and, in view of the many uses to which an audited balance-sheet may be put, of generally protecting his client and those who may be interested in the balance-sheet, and incidentally himself, from possible misunderstanding? Should not the client or the reader of an audited balance-sheet be placed on notice as to both the purpose and the limitations of the audit and have accessible information without which, unless the audit certificate is to do away with all need for intelligent interpretation on the part of the reader, the audited balance-sheet is too often merely a comprehensive note of interrogation? Average clients or readers of a balance-sheet are not familiar with the legal definitions of auditors' duties. More often they entertain fanciful notions regarding them, and, if the auditor is to be fair with his client, it does seem important that the extent of the audit work and its limitations should be succinctly stated; what has not been done being perhaps emphasized more than what has been done. Many a misunderstanding may be thus avoided. This appears especially true when we remember that the average balance-sheet must bear on its face certain assumptions and conclusions reached as a result of inquiry into relative facts, and that the ramifications of the audit work depend largely on the nature and character of the enterprise, the actual conditions and requirements of the business as a whole and its relation to other businesses and to the community. The provisional character of many of the items appearing thereon, contingent and potential values, reliance on certain premises, conventional or otherwise, all call for

careful consideration in the presentation of the result of the auditor's work.

No limitations can be recognized in the verification of cash assets, the existence of which, in proper custody, must be determined.

Accounts receivable need not be, and often are not, verified by independent communication, although in cases where the books and records of the concern bear evidence of their unreliability and are not susceptible to satisfactory internal verification, the auditor is in duty bound to except them in any certificate he may furnish; or if the accounts receivable constituted the principal asset of the business, he might not be justified in certifying the balance-sheet at all unless he were permitted to communicate with the parties concerned.

Notes are accepted at their face value, and nothing short of warranted suspicion as to their bona-fides would ordinarily justify an auditor in going further.

From the history of these receivable items and careful inquiry, the auditor should satisfy himself that due provision has been made for probably uncollectible items.

The verification of merchandise inventory is subject to limitation as to the physical correctness of its make-up and the condition of the items listed thereon. It is customary to take a certificate from the parties responsible for the inventory and confine the audit work to checking its clerical accuracy, the prices used, and ascertaining that no items are included thereon for which payment has not been made and the liability therefor not duly set up. While this procedure would ordinarily cover the legal responsibility of the auditor, the importance of the terms "reasonable care, skill and diligence" must not be overlooked. An instance recently occurred where the procedure outlined above had been followed. In reviewing the balance-sheet after audit, three salient features of the inventories were apparent—

1. The inventories were by far the largest items on the balance-sheet.
2. The inventories at the end of the year under review were more than twice what they were at the end of the previous year (nearly all the increase was in manufactured stock).
3. The concern had sustained a substantial operating loss during the year.

Further investigation disclosed the fact that about ninety per cent. of the finished stock had been manufactured under contracts, according to special specifications, for certain mushroom growth manufacturers of world-war origin, delivery had been refused, and the other parties to the contract were financially unable to accept delivery and practically bankrupt. As a result of this disclosure, the inventory was adjusted to reflect the anticipated loss from cost to junk value, and by reason of this adjustment alone a friendly receivership ensued. The concern is slowly recovering. It has since been clearly demonstrated that had attention not been called to the conditions, the receivership would have been deferred, but it would not have been a friendly one and its termination unquestionably would have been disastrous.

A careful review of the manufacturing or trading account will sometimes reveal abnormalities which point to evident error in the inventory. In such cases the auditor must exhaust every reasonable means to ascertain the cause of such abnormality and as a result thereof may require a revision of the inventory.

The degree of limitation in the audit work in relation to inventories must also depend largely on the relative importance which the inventory bears to the balance-sheet as a whole.

In the case of mining or oil-producing companies, the auditor would not be expected to pass on depletion reserves, except to assure himself that the estimate of ore or oil on hand had been furnished by some competent person or source and that the reserve set up had been correctly calculated on the output or yield in its ratio to such estimate.

In the verification of fixed assets, such as real estate, buildings, machinery, equipment, furniture and fixtures, no limitation would ordinarily operate against the verification of title record, cost, propriety of all items charged to such accounts, and the absence of any liens or liabilities thereon not disclosed on the books. It is sometimes deemed advisable to take a certificate from the client, or in the case of a corporation from a responsible officer, to the effect that no liabilities other than those shown on the books exist. This is especially desirable in the case of partnerships or individual businesses, or what are known as one man or family corporations, where transactions in their recording are given neither the attention nor formality which they should receive, and such a thing as the mere giving of a note is not always shown on the books.

In conclusion, the following instance of what might be termed "unlimited limitations" may not be inappropriate or without interest:

A certified balance-sheet was requested. The purpose of the audit was to furnish such certified balance-sheet to prospective purchasers of stock, although this purpose was not disclosed till later. The company owned investments (common stock) in subsidiary companies for which the holding company had paid nothing—the stock was received in payment for services in promotion and organization. This stock was carried on the holding company's books at about \$1,000,000.00. The books of the subsidiary companies, which numbered twenty, showed that twelve had an aggregate earned undistributed surplus (no dividends paid) of about \$32,000.00; while the other eight showed an aggregate deficit (all operating loss) of about \$15,000.00. The holding corporation owned about 90% of each subsidiary company's common capital stock. The auditors were requested to increase the value of this investment in the subsidiary companies to \$2,000,000.00 on the balance-sheet of the holding company, on the ground that the stock could be readily sold at a price to yield that amount.

Unwillingness on the part of the auditors brought the corporation's attorneys to convince them and to disabuse their minds of any misunderstanding as to what they were engaged to do. After some discussion as to auditors' duties generally, the following accommodating suggestion was offered:

Either the auditors might receive limited instructions withdrawing the troublesome investments which would then appear at a value of \$2,000,000.00 from within the scope of the audit, and the auditors might protect themselves by stating in the accompanying report, if they thought it necessary, that under the instructions received the said investments were not verified, or they would be furnished with affidavits as to the value sought to be placed upon these investments in the balance-sheet. The attorneys impressed the auditors with the fact that they would thus have fully protected themselves and fully discharged their duty legally.

A counter suggestion was made by the auditors that if a value of about \$30,000.00 was used in the balance-sheet and the manner in which such value was computed was set forth in the report, there would be nothing to prevent any intelligent person from being convinced as to any potential value beyond that shown on

the balance-sheet which this investment might have, but that for audited balance-sheet purposes fanciful valuations could not be accepted.

The investment in the subsidiary companies was shown on the audited balance-sheet at an amount equal to 90% of the \$32,000.00 aggregate undistributed surplus. The audited balance-sheet was rejected by the holding company, which refused to pay the audit fee on the grounds that the auditors had presumed to appraise property which the clients held was not within the duties or functions of an auditor. As a matter of fact, the auditors had refrained from any attempt to appraise, but had declined to accept an appraisal by interested parties, and this of course was the real reason for the clients' objection. A suggestion that the courts be asked to pass on the clients' contention led to the acceptance of the audited balance-sheet, and thus ended an unpleasant incident in which the auditors had been tempted by instructions with limitations and by assurances as to legal immunity to become a party to deliberate misrepresentation.

Accounting for a Portland Cement Mill

By HAROLD S. MEINHARDT

Before discussing the accounts of a Portland cement mill a few words relative to the product may be in order. The cement which is generally used in the construction of concrete roads, tunnels, bridges, buildings, etc., is known as Portland cement. It is the strongest and most durable form of cement and will set or harden under water. The name was derived from its resemblance in color to a natural stone found at Portland, England. There is no definite chemical formula for Portland cement, although the concrete made from it must meet certain requirements from a structural point of view.

Portland cement is made by burning a mixture of pulverized materials that contain compounds of calcium carbonate, silica, alumina and iron oxide in the proper proportions. The forms of calcareous matter used are limestone, chalk or marl and for convenience will be referred to hereinafter as "material No. 1." For the silica, alumina and iron contents, which will be referred to as "material No. 2," clay, shale, slate or blast-furnace slag is used.

The manufacturing process may be described briefly as follows:

The first step is the excavation of the raw materials. As the plant is usually situated in proximity to the quarries, the raw materials are carried directly to the rock crushers and grinders.

The second step is the crushing, grinding and mixing of the raw materials. If the "dry process" is to be used, proper proportions of material No. 1 and material No. 2 are mixed after being thoroughly dried. The "wet process" is more common, however, as the mixing can be done more efficiently with the aid of water. The mixture is a thin mud known as "slurry." As the quality of the cement depends upon the fineness of the mixture as well as its composition, the slurry is stored in large tanks until it has been analyzed and approved by the chemical laboratory.

The third step is a chemical process, being the burning or calcining of the raw materials. The slurry is fed into the upper end of the kiln, which is a slightly inclined, revolving cylinder from five to nine feet in diameter and from sixty to two hundred

feet in length. The kiln is made of sheet steel lined with fire brick, and is heated to a temperature of from 2,000° to 4,000° F. by the combustion of jets of oil or pulverized coal and air which are blown in at the lower end of the kiln. The water evaporates immediately and the mixture forms a chemical combination known as Portland cement clinker. The clinker, in the form of small pebbles, rolls out at the lower end of the kiln into another revolving cylinder where it is cooled by passing a current of air over it. The current of air is thereby heated and is used to facilitate the combustion in the kiln. The clinker is then placed in storage until it has seasoned, when it is ready for the finishing mill.

The fourth and final step is the grinding of the clinker, to which is added a small quantity of gypsum to prevent the cement from setting too rapidly when it is used. The product is now Portland cement and is conveyed to immense bins where it is stored awaiting shipment, at which time it is packed into barrels, cloth sacks or paper bags.

ACCOUNTS

It is not intended to describe in detail the accounting systems which have been devised by the trade associations and are being used by the cement companies, but the following condensed chart of accounts may serve to indicate the nature of the accounts:

Plant accounts:

- Mill land
- Buildings
- Machinery
- Quarry lands

Investments

Inventories:

- Cement
- Clinker
- Raw materials
- Gypsum
- Coal (kilns—power house)
- Packages (sacks, barrels, paper bags)
- Stores

Accounts receivable:

- Customers'
- Advances
- Bills receivable

Cash

Deferred charges:

- Shut-down expense

Insurance unexpired
Taxes prepaid
Capital stock
Bonds
Current liabilities:
 Bills payable
 Trade accounts payable
 Unclaimed sacks
 Payroll accrued
 Bond interest accrued
 Taxes accrued
 Royalties accrued
Reserves:
 Depreciation of buildings
 Depreciation of machinery
 Depletion of quarry lands
 Contingencies
 Doubtful accounts
 Redemption of sacks (unearned profit)
Surplus
Profit and loss
Manufacturing expenses:
 Quarrying
 Raw grinding
 Clinker burning
 Clinker grinding
 Mill overhead
Sack and shipping expenses:
 Sack cost
 Sack handling
 Sack allowances
 Packing and loading
Selling expenses:
 Sales office salaries
 Sales office expenses
 Salesmen's salaries
 Salesmen's expenses
 Advertising
 Commissions
 Association dues
General and administrative expenses:
 Officers' salaries
 Office salaries
 Rent, heat and light
 Stationery and printing
 Telegraph and telephone

Postage
Legal expenses
Miscellaneous expenses
Interest paid
Bad debts
Federal income taxes
Sales:
 Sales allowances
 Discount on sales
Interest received
Discount on purchases
Unclaimed sacks
Foreign sacks unclaimed
Miscellaneous income

Subsidiary ledgers are kept for the plant accounts, inventories, accounts receivable, etc. The operating accounts, which are found in the cost ledger, may be summarized under the following general groups which embrace the accounts up to "bin cost":

1. Quarrying:
 - Operating labor
 - Operating supplies
 - Repair and maintenance labor
 - Repair and maintenance materials
 - Power
 - Fuel
 - Explosives
 - Quarry overhead
 - Insurance
 - Taxes
 - Depreciation
 - Depletion of quarry lands
2. Raw grinding:
 - Raw materials used
 - Operating labor
 - Operating supplies.
 - Repair and maintenance labor
 - Repair and maintenance materials
 - Power
3. Clinker burning:
 - Fuel
 - Operating labor
 - Operating supplies
 - Repair and maintenance labor
 - Repair and maintenance materials
 - Power

4. Clinker grinding:
 - Clinker used
 - Gypsum used
 - Operating labor
 - Operating supplies
 - Repair and maintenance labor
 - Repair and maintenance materials
 - Power
5. Mill overhead:
 - Superintendence
 - Mill office and storeroom
 - Laboratory
 - Machine-shop overhead
 - Shut-down expenses
 - Maintenance of yard and buildings
 - Insurance
 - Taxes—state and local
 - Depreciation of buildings
 - Miscellaneous

The "bin cost" of cement, as determined by a summary of the above accounts, is transferred to the cement inventory account. By summarizing the quantities shown in the daily production and sales reports a book inventory is obtained from which the average cost per barrel, as well as the value of the inventory at the end of the period, can be determined. The cost of cement sold is obtained by crediting the cement-inventory account with the inventory at the end of the period. By adding the shipping expenses the "cost on board cars" is obtained.

The determination of costs depends upon the accuracy of the production figures and the physical inventories. The production figures are estimates and may be calculated, for instance, from the amount of slurry that has been extracted from the slurry tanks. It is necessary, therefore, that periodical physical inventories be taken to check the accuracy of such records. But the physical inventory is also an estimate because of the difficulty of measuring the cement in the bins. The bins are almost inaccessible to the surveyor, whose task is complicated further by the extent to which the cement is packed down. Monthly physical inventories are therefore out of the question. A check upon the book inventories may be maintained, however, by comparing the quantities shown by the bin records with the actual quantities in such bins as can be gauged accurately, particularly bins which have been emptied.

A similar situation exists in the records for quarrying, except that here the accuracy of the records is not of such importance because the values involved are not so great. The quantity of rock produced does, however, determine the amount charged for depletion of quarry lands, which is calculated on the following basis:

From the cost of the quarry lands is deducted the residual value, if any, of the lands after quarrying. This amount divided by the number of tons of rock or clay which it is estimated by the engineers is commercially available will give the depletion charge per ton, which is added to the cost of every ton of raw material quarried.

The mill-overhead accounts do not contain any unusual items except perhaps the account "shut-down expense." It is customary for many mills to suspend operations during the winter months on account of the falling off of orders and the increased cost of operation, particularly in the quarries. As the kilns operate continuously for twenty-four hours a day during the remainder of the year, an opportunity is afforded during the shut-down period for general overhauling and repairs. The cost of such repairs, as well as the mill-overhead expenses for the shut-down period, are charged to a deferred-asset account which is written off to manufacturing costs in equal instalments during the remainder of the fiscal year.

Portland cement is generally quoted in terms of barrels containing 380 pounds, but the cement is seldom shipped in barrels. It is sometimes shipped in paper bags at the customer's risk of breakage. The almost universal method of shipment, however, is in cloth sacks, each of which contains one-fourth of a barrel of cement. The customer is charged a standard price for the sacks and the company agrees to repurchase such second-hand sacks as are returned by the customer in good condition.

In the above chart of accounts the item "unclaimed sacks," which is shown as miscellaneous income, represents the elimination from the accounts of the liability for returned sacks, the shippers of which could not be ascertained or which were not claimed by customers. The liability is carried for at least two years before it is written off. Customers sometimes inadvertently return sacks branded with another cement company's trade-mark. Such "foreign sacks" are held for the customers' instructions for

a period of thirty days, after which they are deemed to have been forfeited by the customers and may then be sold to the respective cement companies.

The treatment of the sack accounts presents an interesting problem in accounting. Before the war the price quoted for a barrel of cement included 40 cents for the four cloth sacks. The sacks ordinarily cost the company less than 10 cents each when new, so that the problem here was whether the excess of selling price, 10 cents, over cost was an earned profit, in view of the fact that the company agreed to repurchase the sacks at 10 cents, and also contracted to count, inspect, clean and if necessary repair sacks when returned. Various solutions were offered, the soundest of which provided for the setting up of the unearned profit as a reserve for redemption of sacks.

During the war, however, on account of the advance in the price of cotton, the cost of new sacks increased to about 25 cents each. The standard price to the customer was therefore raised by some companies during 1918 to 25 cents.

The proper redemption of the sacks is accomplished by keeping a memorandum of the number of sacks in the hands of each customer at the various prices, and the sacks themselves bear some distinguishing mark to indicate to which lot they belong. When a customer returns sacks which he has purchased at 25 cents each, his account is credited with 25 cents; but the sack inventory account is charged with only the average cost which prevailed at the time when the sacks were sold to the customer, the difference being charged to the reserve for redemption of sacks. Inasmuch as sacks lose their identity as soon as shipped, the cost which prevailed at the time the sacks were sold is determined for practical purposes by crediting to the inventory account the oldest relative portion of the reserve.

At the time when 25-cent sacks are being returned, 10-cent and 15-cent sacks are also coming in for redemption, for which perhaps no reserve has been provided because the average cost at the time of sale was more than 10 cents or 15 cents, respectively. It seems reasonable, in this case, to charge the inventory account with the price at which the sacks were repurchased, namely, 10 or 15 cents.

The sack inventory account then reflects an average cost per sack which is not in excess of original cost, but below cost in

some instances. The average cost will be reduced toward the present selling price of 10 cents as the inventory is turned over, so that the loss will be absorbed in costs over the period during which the high-priced sacks are used. It is therefore customary to state the inventory of sacks at average cost and as they are sold to charge the excess of cost over selling price to shipping expenses. If the selling price, however, is greater than cost, conservatism demands that such profit be regarded as unearned until the particular lot of sacks is no longer in use.

In the case of a company which has on hand a large number of sacks that were acquired at high prices, it would seem that the inventory should be stated at the present selling price rather than at average cost. Although this would be the conservative course to follow, many companies do not wish to charge such a radical reduction in the value of their sack inventory to the earnings of any particular period. The accounting procedure described above, whereby the values are reduced gradually, has therefore met with favor. As to reducing the sack inventory to market it will be seen that the market quotations for new sacks have no bearing upon the value of sacks which are branded with the company's trade-mark. Regardless of their value, they will be sold to customers and repurchased from them at the present arbitrary price of 10 cents each. The question remains as to whether or not the books should reflect the liability of the company for the repurchase of sacks in the hands of customers. The company is contingently liable, and, theoretically, the liability should be reflected in the balance-sheet. A going concern, however, may safely ignore such liability because it will need the second-hand sacks which it purchases from its customers and it can sell them again for the same price which it pays for them. It is true, however, that where the company has contracted to pay 15 cents or 25 cents for a sack which it will resell for only 10 cents, a loss will be incurred for which due provision should be made. The reserve for redemption of sacks mentioned above will provide for the difference between 15 cents or 25 cents and the cost when the sack was sold to the customer, but the cement companies do not always provide for the further reduction to 10 cents. The conservative thing to do, however, is to provide a reserve for redemption of sacks which will be adequate to provide for a 10-cent valuation of all sacks which are to be redeemed at higher prices.

Cost Systems and Operating Statistics

By A. F. WAGNER

Business conditions during 1921 again impressed executives with the fact that timely operating and balance-sheet information is indispensable to intelligent and, consequently, profitable management. Observation leads to the conclusion that adequate current statistics in many instances enabled executives to determine policies which not only prevented losses but often resulted in a considerable net profit.

In almost every field of business during the deflation period there have been a few outstanding concerns which, by reason of their profitable operation or avoidance of operating losses common to the trade, have earned the respect of their stockholders, bankers and less fortunate competitors. The marked contrasts in operating results (which public accountants have recently been privileged to witness) can be largely attributed to disparities in managerial ability. Furthermore, foresighted executives have been consistently fortified with accurate statements of operation and financial position received at frequent, regular intervals.

The aim of this paper is to point out the statistical inadequacy of many cost systems designed and installed before the United States entered the world war and to propose a simple supplement to existing cost records by means of which valuable additional statistics can be easily prepared for executives.

The directing heads of large or even moderate-sized manufacturing enterprises do not and cannot profitably take the time to study all detailed costs of separate articles or jobs; but they should have monthly statements from which they can determine the ratio of the various component elements entering into the cost of product manufactured, that is, materials, labor and overhead. Furthermore, is it not desirable for a manufacturer to know from month to month the average rate at which his inventories of materials and finished goods are being turned and the average length of time that goods remain in process of manufacture? All real merchants closely watch the turnover of their goods in order to avoid excessive investment in inventories, but many manufacturers apparently forget that one of their functions is merchandising materials as well as changing their form.

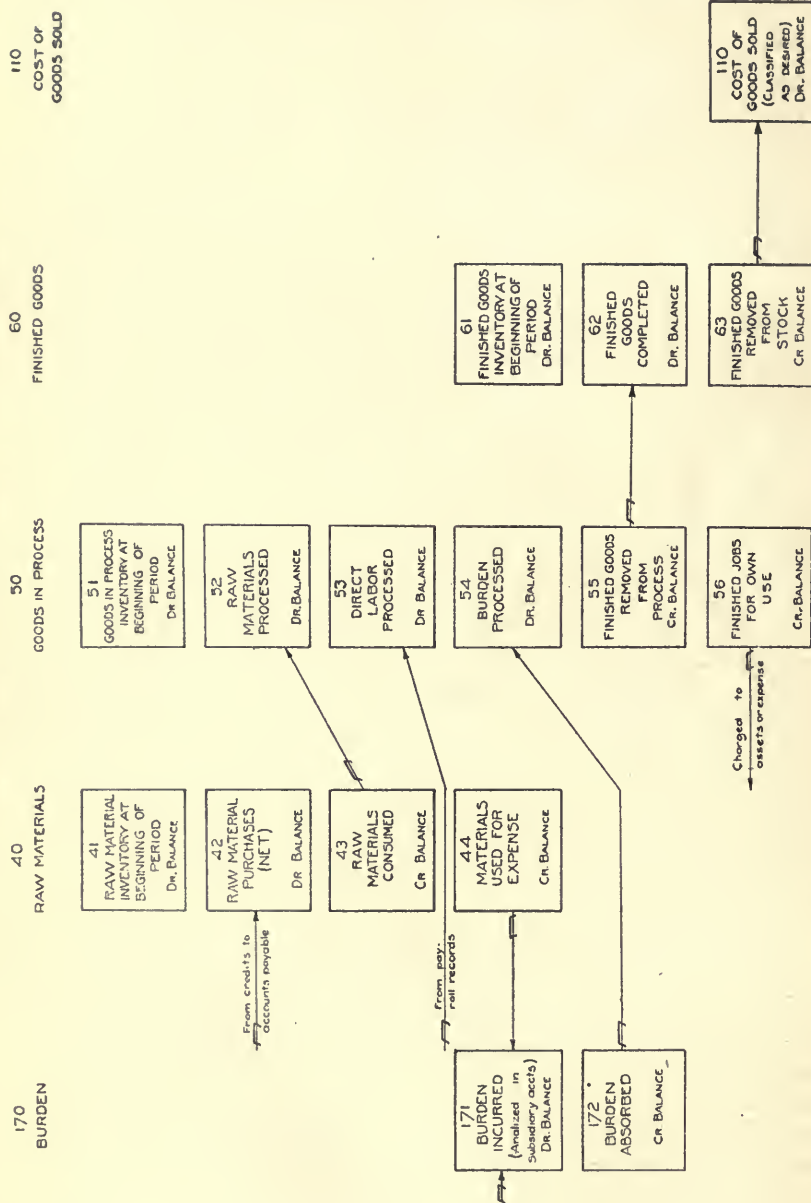
Established maximum and minimum quantities of materials or general instructions concerning such limits may be disregarded by purchasing agents—how can the management judge the efficiency of such subordinates unless current statistics reveal the average length of time that articles are on hand or in process of manufacture? Managers should be constantly striving to shorten the period of time between receipt of raw materials and shipment of finished product; accountants should provide executives with data which indicate the results of changes in policies and whether or not additional steps are necessary to accomplish a desired end.

Data described in the foregoing may be easily obtained from most "tied in" cost systems now in operation if proper analyses of accounts be made. The writer suggests that the classification of general and cost-ledger accounts be so changed that the necessary details will automatically appear in the company's records. A chart (exhibit "A," page 200) illustrates the operation of such a classification of accounts. The arrangement therein set forth consists simply in running analyses of the usual perpetual inventory accounts. This classification can be expanded to include as many kinds of materials, work-in-process and finished goods as may be desirable in a particular case and can be readily fitted to any plan of departmental operations. The accounts listed in the chart may be further amplified so as to subdivide the balances of goods in process, finished goods and cost of goods sold into their component parts, namely, materials, labor and burden. Account number 44, materials used for expense, has been included on the chart because some manufacturing companies purchase materials which are used both directly in the product and indirectly in factory operations.

With the operating details of a manufacturing plant perpetually analyzed as indicated in the chart, monthly statements similar to the specimen presented in exhibit "B" (page 201) can be promptly prepared. Such statements, when furnished executives, should contain comparative figures for the corresponding periods of the preceding year. The relationship between inventories and movement of goods is brought forcibly to the attention of a manager studying reports in this form. The data on turnover submitted at the bottom of exhibit "B" are calculated in the usual manner by dividing average inventories into cost of

EXHIBIT "A"

CHART ILLUSTRATING OPERATION OF SUBSIDIARY COST LEDGER ACCOUNTS



NOTE: Account captions at head of chart indicate general ledger accounts which control the subsidiary accounts directly thereunder. Accounts 40, 50 and 60 are the usual perpetual inventory accounts. The balance in account 170 represents the amount of burden over or under-absorbed. Account numbers hereon are the same as those listed in Exhibit "B".

EXHIBIT "B"

Specimen Statement of Cost of Goods Sold (With account numbers referring to chart presented in exhibit "A")

	Month of July, 1920	Twelve Months ended July 31, 1920
Raw materials:		
Inventory at beginning of period (No. 41)	\$298,910.00	\$ 238,840.00
Net purchases (including inward freight) (No. 42)	68,730.00	649,340.00
Less: Expense materials (No. 44)		888,180.00
Inventory at end of period (No. 40)	367,640.00	\$ 3,930.00
		316,370.00
Materials used in manufacturing (No. 52)		
Manufacturing burden:		
Indirect labor (No. 171a)	4,810.00	56,120.00
Superintendence (No. 171b)	2,500.00	29,750.00
Loose tools, etc. (No. 171c)	2,830.00	29,930.00
Power (No. 171d)	1,020.00	16,930.00
Fuel (No. 171e)	970.00	12,370.00
Repairs (No. 171f)	1,130.00	12,590.00
Depreciation of plant (No. 171g)	1,300.00	15,560.00
Other manufacturing expenses (No. 171h)	1,410.00	16,460.00
Total burden incurred (No. 171)	15,970.00	189,710.00
Plus: Burden over-absorbed (No. 170)	660.00	9,980.00
Burden charged into process (No. 54)	16,630.00	199,690.00
Total goods processed	93,820.00	1,097,790.00
Deduct: Goods manufactured for own use (No. 56)		3,950.00
Total goods processed for sale	93,820.00	1,093,840.00
Add: Inventory of goods in process at beginning of period (No. 51)	178,910.00	155,750.00
Deduct: Inventory of goods in process at end of period (No. 50)	272,730.00	1,249,590.00
Cost of goods completed (No. 62)	210,650.00	210,650.00
Add: Inventory of finished goods at beginning of period (No. 61)	62,080.00	1,038,940.00
Deduct: Inventory of finished goods at end of period (No. 60)	113,210.00	148,990.00
Cost of goods sold (No. 110)	175,290.00	1,187,930.00
Percentages of elements of total goods processed:		
Raw materials	33,520.00	33,520.00
Direct labor		
Manufacturing burden		
Totals	\$141,770.00	\$1,154,410.00
Approximate data on turnover of goods:		
Raw materials	54.4%	Average
Goods in process	27.9	Inventory
Finished goods	17.7	Turnover
		100.0%
		Rate of Annual
		Turnover
		100.0%
		Rate of Annual
		Turnover
		1.9
		6.1
		10.2
		113,510.00
		\$298,720.00
		\$171,250.00
		\$113,510.00

goods moved and may also be stated in terms of *average* length of time that goods are on hand or in process, as follows:

	Rate of movement of goods in terms of average number of months on hand	
	Month of July, 1921	Twelve months to July 31, 1921
Raw materials	6.0 Mo.	6.3 Mo.
Goods in process.....	2.1 "	2.0 "
Finished goods	0.5 "	1.2 "
Average total period from receipt of raw materials to shipment of product manufactured therefrom	8.6 Mo.	9.5 Mo.

Statistics similar to the foregoing (especially when compared with like data for prior years) are of real value to managers. Furthermore, they can be prepared from almost any good, existing cost system. The only additional records required are the subsidiary accounts set forth in the appended chart, and these may be dispensed with by the use of multi-column ledger sheets.

The classification and analyses suggested in this paper have one additional advantage, namely, that the treasury department's requirements as to form of the statement of cost of goods sold on annual returns of income can be strictly followed without hurried analyses of accounts at the end of the year. The suggestions presented in this paper are offered, not with a view of eliminating unit costs, percentages of normal production and other valuable data now secured from cost systems, but rather with the idea that analyses be added which will afford executives additional indices of the efficiency of operations. Actual experience with records such as those described herein has demonstrated that they require no greater time than was necessary before the running analyses were added and, furthermore, that real operating statistics and annual returns of income are now more expeditiously prepared than was the case before the records were changed.

The JOURNAL of ACCOUNTANCY

Official Organ of the AMERICAN INSTITUTE of ACCOUNTANTS

A. P. RICHARDSON, *Editor*

EDITORIAL

What Is Accountancy?

From time to time it is the practice of this magazine to draw attention to advertisements which indicate a lack of knowledge of what constitutes accountancy. We are particularly interested in advertisements of educational institutions.

For example, the *New York Times* of July 25th contained an advertisement in which the following appeared:

“Register now to become a junior accountant by December, 1922. Salary range, \$35 to \$50 per week, and
“Senior accountant by June, 1923. Salary range, \$50 to \$200 per week.”

The advertisement appeared on July 25th. This would have given the applicant if he had applied at once a little over four months in which to become a junior accountant and demand a salary of \$35 to \$50 a week. This might happen. It is conceivable that a bright young man or woman could receive enough training in that length of time to merit employment as an extremely junior junior. If the firm were generous the salary might be paid.

The real feature of the quotation, however, is the thought that in less than a year one may become a senior accountant and demand a salary of from \$2,600 to \$10,400 a year.

We have a fairly wide range of acquaintance among accounting firms. It is known to everyone that occasionally a man may be engaged as a senior and be paid a fair salary without proper investigation as to his ability. We maintain, however, that the accountant who would offer even \$50 a week to an applicant who had had less than a year's training or experience would be either a philanthropist or a fit subject for observation in the psychopathic ward.

And yet, no doubt, there are scores of young men and women who would be encouraged by such an advertisement and would be quite properly disappointed at the end of the time to find that the promises could not be made good.

Mail-order Prices

A few days ago we received copy of a circular issued by a concern representing itself as an investment brokerage house describing in a great deal of detail and with the usual optimism an issue of bonds of a corporation supposed to be engaged in the production of an important commodity.

The circular had been sent to a physician in a country town who called up the office of this paper to obtain some information in regard to the corporation and to the brokerage house.

Neither of the subjects of inquiry was known to us, but investigations were made. It was discovered that the brokerage house apparently had desk-room in another office, and it was further discovered that there was such an issue of bonds by the corporation which had been mentioned.

There is nothing absolutely thrilling in the recitation of events so far, but when it is explained that the brokerage house was offering these bonds at 105 and that they could be bought on the street for 67 the matter begins to be interesting.

Upon inquiry it appears that there may be nothing absolutely illegal in the actions of the so-called brokerage house. Under the doctrine that the buyer should beware there is perhaps no cause for complaint in such a case as this. But there is a great deal to be said on the ground of common honesty.

Of course, no one can have much sympathy with an investor who will deal with an unknown house in unknown securities. It is the existence of many gullible persons which is responsible for the great number of unethical if not absolutely illegal transactions daily conducted. Of recent years, however, there has been a tendency to protect the buyer against himself, and it is increasingly difficult for wild-cat stocks and bonds to find a market. But so far there is nothing except public opinion to prevent a dealer in securities from charging his unsuspecting customer any price which the customer will pay.

Here is a field for investigation and the suggestion of protective legislation. It seems to us that it would be possible to enact a law preventing public offering of securities at any price varying more than a few points from the legitimate market.

Annual Meeting of American Institute

Attention of our readers is drawn once more to the annual meeting of the American Institute of Accountants which is to be held in Chicago, September 19th and 20th. The programme includes papers of exceptional interest and there are to be many matters of professional importance under discussion.

Beta Alpha Psi

Accounting instruction has reached such a high scholastic plane in some of the universities of the country that the students have sought recognition for their efforts through an honorary professional fraternity known as Beta Alpha Psi.

Membership in this fraternity is obtained by invitation only and is based on a high scholastic standing in accounting courses pursued in the university, good moral character and an expressed interest in the accounting profession. One of its main purposes, as stated in the constitution, is to encourage and foster service as the basis of the accounting profession and to secure the highest ethical ideals in the practice of accountancy. The members of the several chapters hold regular meetings at which they discuss accounting subjects and listen to articles prepared and read by the members. These meetings afford excellent opportunities for the discussion of interesting topics that cannot be included in class-room schedules because of lack of time. In the institutions where this fraternity has chapters the members have a reputation for doing things. They seem to take more interest in the work of the organization than do the members of a great many other honorary or professional fraternities.

At present there are chapters at the University of Illinois (where the fraternity was founded), Northwestern University, University of Washington, University of Oregon and Oregon Agricultural College.

Such an organization as this should be a source of inspiration for the young accountants who hope to be the leaders of the profession in the future. It should be a distinguishing mark for the accounting student as Beta Gamma Sigma is for the commerce student in general or Phi Beta Kappa for the student of literature and arts.

Income-tax Department

Edited by STEPHEN G. RUSK.

The district court of the United States, southern district of Ohio, has made an interesting decision with respect to the features that must be present in the business transacted by building and loan associations if they are to be exempt from the provisions of the revenue act of 1918. To those familiar with the law and regulations relating to exempt associations of this kind it is difficult to understand why a suit should be brought to establish itself as exempt by a building and loan association that has "as its chief business dealing for profit with the general public by the methods of an ordinary savings bank." The court for this reason among others held that the Lilley Building & Loan Co. was not entitled to exemption from income taxes.

Stock subscription rights are dealt with in a comprehensive manner by the supreme court of the United States in the case of *Miles, Collector, versus Safe Deposit & Trust Company, Guardian*. The questions as to rights and responsibilities of taxpayers owning or dealing in such rights to stock may be considered as definitely answered by this decision.

A decision of importance is that (No. 3367) which amends article 836 of regulations 62. The amending language sets forth quite definitely the proof required by the department of internal revenue of corporations which seek to include in invested capital "tangible property paid in; value in excess of par value of stock." The limitations as to appraisals as proof will be better understood as a result of this amendment of article 836. There are many corporations that are unquestionably entitled to include in invested capital such tangible property, but have found it difficult to furnish proof of the fact because of lack of knowledge as to what would be accepted as proof. It is probable that the text of this article will be amplified further when the taxing officers obtain more experience by handling concrete cases of the kind involved by the section of the revenue acts dealing with this difficult question.

TREASURY RULINGS

(T. D. 3355, June 17, 1922.)

Income tax—Revenue act of 1918—Decision of court.

1. EXEMPTIONS—BUILDING AND LOAN ASSOCIATIONS—ESSENTIAL CHARACTERISTICS.

Mutuality is the essential principle of a building and loan association. Its object is to raise a fund to be loaned among its members or such as may desire to avail themselves of the privilege. Its business is confined to its members.

2. BUILDING AND LOAN ASSOCIATIONS—EXEMPTION FROM TAX.

When a building and loan association ceases to be substantially mutual and adopts as its chief business dealing for profit with the general public by the methods of an ordinary savings bank, it is no longer entitled to exemption under section 231, paragraph 4, of the revenue act of 1918.

3. SAME—INCIDENTAL TRANSACTIONS.

The making of loans to nonmembers or borrowing from nonmembers does not defeat exemption under section 231, paragraph 4, of the revenue act of 1918, if such transactions are simply incidental to the primary business of operating a building and loan association.

The appended decision of the United States district court, southern district of Ohio, eastern division, in the case of the *Lilley Building & Loan Co. v. Newton M. Miller, collector*, is published for the information of internal revenue officers and others.

DISTRICT COURT OF THE UNITED STATES, SOUTHERN DISTRICT OF OHIO,
EASTERN DIVISION, No. 2105.

*The Lilley Building & Loan Company, plaintiff, v. Newton M. Miller, as
Collector of Internal Revenue, etc., defendant.*

PECK, district judge: Action to recover corporate income taxes paid under protest for the years 1918, 1919, and 1920, under the revenue act of 1918. Submitted on the evidence, without jury.

The essential question is whether the plaintiff was exempt from the tax. Section 231 (4) exempts "domestic building and loan associations and cooperative banks without capital stock, organized and operated for mutual purposes and without profit." It is claimed by the government that the plaintiff does a banking business under the guise of a building association; by the defendant, that its activities are no broader than those permitted to be exercised by such associations organized under the laws of Ohio. *General Code Ohio*, 9643, et seq.

The facts are not in dispute. Plaintiff does not hold meetings at stated intervals, as such associations frequently do, but keeps its place of business open during the usual business hours of the day.

It receives deposits from nonmembers, evidenced by entries in books such as are ordinarily used by savings banks. Withdrawals may be made on presentation of books. On these accounts (which constitute the bulk of its business) it pays interest at the stated rate of 4 per cent. It also receives time deposits, for which it issues certificates bearing interest at the rate of 5 per cent. It has paid-up stock, also "running stock," on which instalment payments are made. Both classes of stock receive semiannual dividends at the rate of 5 per cent per annum. Its statement for the year 1920, which may be taken as typical of the period of time involved, shows running stock at \$121,000; paid-up stock at \$123,000; deposits of \$830,000; borrowed money, \$20,000; and a reserve fund of \$18,500 (odd figures are omitted). Its stockholders numbered 301; its borrowers 495, of whom but two were stockholders; and its savings depositors were 2,239. Its loans were all made upon homes, the average amount of each being about \$3,500. It had no checking accounts. A depositor wishing to make a withdrawal presented his passbook and for the amount was given a check to his own order, which he indorsed and returned to the association, receiving thereon the cash. The association then put the check through its bank. Its mortgage loans were usually payable in monthly instalments. The few loans made to members took the

same course as those to nonmembers. The borrowing members gave their notes and paid them off in instalments, such obligations being entirely disassociated from their obligations to pay for stock. The ordinary building association method of subscribing for stock to the amount of the loan, the stock when paid up extinguishing the loan, was not pursued.

It may be observed that about 80 per cent of its receipts and 97 per cent of its loans are transactions with nonmembers. Thus, by far the greater number of those with whom it does business have no interest in its profits, and as long as it remains solvent they have none in its losses. The earnings accrue to the stockholders. Mutuality of interest between stockholders, on the one hand, and the depositors and borrowers, on the other, is lacking.

This course of business seems to be within its charter powers as prescribed by the statutes of Ohio, particularly sections 9648 and 9657, *General Code* of Ohio. It does not, however, conform to the general conception of the functions of such an association. "Mutuality is the essential principle of a building association. Its business is confined to its own members; its object being to raise a fund to be loaned among themselves, or such as may desire to avail themselves of the privilege." *Eversmann v. Schmitt* (53 O. S. 175, 184). "The leading feature of such an association is that its members are kept upon a strictly co-operative basis with mutual advantages and benefits, sharing alike in the profits and sustaining their proportionate share of the losses." 4 R. C. L. *Building and Loan Associations* (p. 344). In *Halsell v. Merchants Insurance Co.* (105 Miss. 268) a concern organized under the building association act of the state of Mississippi, with powers similar to those exercised by the plaintiff, was held not to be such an association in the real meaning of the term. Having regard, therefore, to its general character as distinguished from its mere charter powers, there is no doubt that the business conducted was in the main not that of a building association as ordinarily conceived.

Plaintiff's counsel, however, contend that the definition adopted by the statutes of Ohio of the term "building association," and not that of general usage, is controlling. But it must be remarked that the statutes referred to do not attempt to define a "building association" as distinguished from a "savings association." "A corporation for the purpose of raising money to be loaned to its members shall be known * * * as a 'building and loan association' or as a 'savings association.'" G. C. 9643. The statutes carry the distinction no further. Both are treated alike. The same powers are conferred on each. Such a corporation may combine both phrases or parts thereof in its name. It may as truly be said that the corporation is designated as "savings association" as a "building association" by the laws of Ohio. Plaintiff has named itself a "building association." It might have named itself a "savings association." Its powers, liabilities, structure, character and place in the law would have been the same. It may even now change its name to a "building association." Would it be exempt as a "savings association"? If not, would it secure exemptions by such change of name, its character remaining precisely the same?

It is pointed out that the revenue acts of 1909 and 1913 exempted domestic building and loan associations "organized and operated exclusively for the mutual benefit of their members"; that these qualifying words were omitted in the act of 1918, that they were restored in the act of 1921 in this phraseology: "* * * domestic building and loan associations substantially all the business of which is confined to making loans to members," and it is argued that the omission of such language in the 1918 statute indicates a purpose of congress to exempt all corporations organized as domestic building associations under the laws of the several states, without any condition or qualification whatsoever; that congress took them with their charter powers and their activities as they existed, and exempted them from the tax; and it is further insisted that the intention of congress to tax them must clearly appear, and that they are not to be taxed by implication. *Gould v. Gould* (245 U. S. 151). But did congress omit the qualifying language in the act of 1918?

Having resort to the text of the act itself, it is to be noticed that the exception concludes with the words "organized and operated for mutual purposes and without profit." In Holmes *Federal Taxes*, 1922 edition, page 318, the author puts a comma before this clause, indicating an interpretation that would make these words modify not only cooperative banks but building associations. While the comma is not found in the act, and the usual presumption is that a phrase modifies its immediate antecedent, yet there is good reason for taking these words as referring to both antecedents. By so doing, the act is in conformity with the general policy of the acts of 1909, 1913 and 1921. Furthermore, there seems to be just as much reason for requiring that building associations, to be exempt, must be organized and operated for mutual purposes and without profit, as there is for applying that requirement to cooperative banks. Plaintiff's interpretation is that corporations organized under building association laws are exempt, although operated not for mutual purposes and with a profit to a limited number of stockholders, be they ever so few. Such an interpretation would seem to violate the intent of the act. Recurring to the matter of nomenclature under the Ohio statutes, if we regard the plaintiff as a "savings association" we would have a mutual bank, *with* capital stock, *not* organized and operated for mutual purposes and *not* without profit. The matter certainly can not rest so lightly as on the arbitrary choice of a name. The facts must control. But if it be linguistically inaccurate to take the adjective phrase in question as modifying "building associations," nevertheless the rule of *nescitur a sociis*, which, in this instance, it seems proper to apply, would lead to the same interpretation.

It is not thought that the making of loans to nonmembers, or borrowing from nonmembers, or receiving deposits to be withdrawn on demand or on time, so long as such transactions are simply incidental to the primary business of operating a mutual building association, would defeat the exemption. In *Central Building Loan & Savings Co. v. Bowland* (216 Fed. 526) the question was whether the existence of such powers necessarily put the corporation out of the exempt class, and it was concluded

that it did not, and that conclusion is thoroughly concurred in. But here the association has put aside the attribute of mutuality; indeed, it is most difficult to distinguish its activities from those of the ordinary savings bank. Its primary design no longer is to be an instrumentality of mutual helpfulness among its contributors in saving and borrowing for home owning, but its object now is the receiving of deposits from and lending money on interest to the public for the profit of the stockholders. Counsel argue that the people are better served thus; that mutuality is inefficient; that a concern of 10 stockholders and many customers is more beneficial to the public than one containing in its body corporate all of its depositors and borrowers. This may be true. But the statute has not exempted all corporations that receive deposits and loan money on homes.

It may not be possible to define precisely how far a building association may go in extraneous activities without losing its essential character, but it seems clear that when it ceases to be substantially mutual and adopts as its chief business dealing for profit with the general public by the methods of an ordinary savings bank, it is no longer a building association entitled to be exempted from income taxation under the statute in question.

It is therefore concluded that the petition must be dismissed.

(T. D. 3365, July 6, 1922.)

Income Taxes—Act of February 24, 1919—Decision of Supreme Court.

1. STOCK SUBSCRIPTION RIGHTS—NATURE—INCOME.

A stockholder's privilege of subscribing to new shares of stock before they are offered to the public is an incident of his stock ownership, and the acquisition of that privilege, while it may increase the value of the stockholder's interest in the corporation, does not constitute a segregation of the profits of the corporation, and is not gain, profit, or income to the stockholder.

2. SAME—SALE OF RIGHTS—EXTENT OF TAX LIABILITY.

A stockholder of a corporation who receives the right to subscribe for shares of a new issue of stock is, on sale of such right, liable to income tax on so much of the proceeds as exceeds the cost of the right (citing *Merchants Loan & Trust Co. v. Smietanka*, T. D. 3173).

3. SAME—SALE OF RIGHTS—COMPUTATION OF GAIN.

The new shares, if and when issued, are indistinguishable from the old shares, and as they are received by reason of the ownership of the old shares, the average of the price paid for the old shares and of the subscribing price for the new shares constitutes cost for either an old share or a new share in computing taxable gain, following the analogy of the computation employed in the case of the sale of stock dividend shares. On the sale of stock rights, cost and selling price are determined by assuming that the stockholder, instead of selling his rights, subscribed for new shares and sold them, and the gain taxable to a stockholder who sells his rights is equal to the gain taxable to a stockholder who subscribes for a new share and sells his new share. In ascertaining the selling price it is assumed that the stockholder, if he had subscribed, would have refused to sell his new share for any amount less than the sum of the subscribing figure and the prevailing price

offered for the rights, and the sum of these two amounts is assumed to represent the selling price of the stock rights. The taxable gain, therefore, is found by taking the sum of the subscribing price and the market value of the rights, and subtracting from that sum the average of (1) the cost of one old share, and (2) the subscribing price of one new share.

4. STOCK SUBSCRIPTION RIGHTS—SALE OF RIGHTS—COMPUTATION OF GAIN.

The acquisition of a new share by the exercise of a right to subscribe is merely an exercise of one of the rights of stock ownership, and until the new share has been sold, no profit has been realized, and there is no taxable income.

SUPREME COURT OF THE UNITED STATES. No. 416. OCTOBER TERM, 1921.
Joshua W. Miles, collector of internal revenue for the district of Maryland,
plaintiff in error, v. Safe Deposit and Trust Co. of Baltimore,
guardian of Frank R. Brown.

ERROR to the district court of the United States for the district of Maryland.
[May 29, 1922.]

Mr. Justice PITNEY delivered the opinion of the court:

D fendant in error, a corporation organized under the laws of Maryland and authorized to act as guardian, was on January 30, 1919, appointed by the orphans court guardian of Frank R. Brown, an infant whose father had died intestate about a year before. The son as next of kin became entitled to 35 shares of the stock of the Hartford Fire Insurance Co., and they were transferred to defendant in error as such guardian, and still are held by it in that capacity. At that time the capital stock of the insurance company issued and outstanding consisted of 20,000 shares of the par value of \$100 each. Later in the year that company, under statutory authority, increased its capital stock to 40,000 shares of the same par value. The resolution of the stockholders sanctioning the increase provided that the right to subscribe to the new issue should be offered to the stockholders at the price of \$150 per share, in the proportion of one share of new stock to each share of stock held by them; subscriptions to be payable in instalments, and the directors to have power to dispose of shares not so subscribed and paid for in such manner as they might determine to be for the best interests of the company. In July, 1919, defendant in error, pursuant to an order of the orphans court, sold the subscription right to 35 shares owned by its ward for \$12,546.80, equivalent to \$358.48 per share. The commissioner of internal revenue, holding that this entire amount was income for the year, under the provisions of the act approved February 24, 1919 (ch. 18, 40 Stat. 1057), assessed and plaintiff in error collected a tax amounting to \$1,130.77 by reason of it. Defendant in error, having paid this under protest and unavailingly appealed to the commissioner, claiming that none of the amount so received was income within the meaning either of the act or of the sixteenth amendment, brought this action against the collector to recover the entire amount of tax so assessed and paid. The case was tried before the district court without a jury on stipulated facts and evidence. Plaintiff's extreme contention that the subscription right to new stock and also the proceeds of the sale of the right were wholly capital and not in any part

subject to be taxed as income, was overruled upon the authority of *Merchants' Loan & Trust Co. v. Smietanka* (255 U. S. 509), then recently decided. The trial court, in the second place, held that, of the proceeds of the sale of the subscription rights, so much only as represented a realized profit over and above the cost to plaintiff of what was sold was taxable as income. In order to compute the amount of the profit, the court commenced with the value of the old shares prior to authorization of the stock increase, which upon the basis of evidence contained in the stipulation was taken to be what they were assessed at by the United States for purposes of the estate tax at the death of the ward's father, viz., \$710 per share, and added the \$150 necessary to be paid by a stockholder or his assignee in order to obtain a share of the new stock, making the cost of two shares (1 old and 1 new) \$860 and half of this the cost of one share.

The sale of the subscription rights at \$358.48, the purchaser to pay the issuing company \$150 per share, was treated as equivalent to a sale of the fully paid shares at \$508.48 each, or \$78.48 in excess of the \$430 which represented their cost to plaintiff; and this difference multiplied by 35, the number of shares or rights sold, yielded \$2,746.80 as the gain realized out of the entire transaction. Upon this the court held plaintiff to have been properly taxable, and upon nothing more, no income tax being assessable with respect to the 35 shares still retained, because although they were considered worth more, ex-rights, than the \$430 per share found to be their cost, the difference could not be regarded as a taxable profit unless or until realized by actual sale (273 Fed. 822). To review the final judgment entered pursuant to the findings and opinion, which sustained only in part plaintiff's demand for a refund of the tax paid, the collector of internal revenue prosecuted a direct writ of error from this court under section 238, *Judicial Code*, because of the constitutional questions involved.

There is but one assignment of error, based upon a single exception, which denied that plaintiff was entitled to recover anything whatever; hence the correctness of the particular recovery awarded is not in form raised; but the trial judge, having the complete facts before him, almost of necessity passed upon them in their entirety in order to determine, according to truth and substance, how much of what plaintiff received was, and how much was not, income in the proper sense, as is proper in a case involving the application of the sixteenth amendment (*Eisner v. Macomber* (252 U. S. 189, 206); *United States v. Phellis* (Nov. 21, 1921, 257 U. S.—); and in order to review the judgment, it will be proper for us to analyze the reasoning upon which it was based.

It is not in dispute that the Hartford Fire Insurance Co. is a corporation of the state of Connecticut and that the stock increase in question was made under authority of certain acts of the legislature and certain resolutions of the stockholders, by which the right to subscribe to the new issue was offered to existing stockholders upon the terms mentioned. It is evident, we think, that such a distribution in and of itself constituted no division of any part of the accumulated profits or surplus of the company, or even of its capital; it was in effect an opportunity given to stockholders to share in contributing additional capital, not to participate in distribution. It was a

recognition by the company that the condition of its affairs warranted an increase of its capital stock to double the par value of that already outstanding, and that the new stock would have a value to the recipients in excess of \$150 per share; a determination that it should be issued pro rata to the existing stockholders, or so many of them as would pay that price. This privilege of itself was not a fruit of stock ownership in the nature of a profit; nor was it a division of any part of the assets of the company.

The right to subscribe to the new stock was but a right to participate, in preference to strangers and on equal terms with other existing stockholders, in the privilege of contributing new capital called for by the corporation—an equity that inheres in stock ownership under such circumstances as a quality inseparable from the capital interest represented by the old stock, recognized so universally as to have become axiomatic in American corporation law.—*Gray v. Portland Bank* (3 Mass. 364); *Atkins v. Albree* (12 Allen 359, 361); *Jones v. Morrison* (31 Minn. 140, 152-153); *Eidman v. Bowman* (58 Ill. 444, 447); *Humboldt Driving Park Ass'n v. Stevens*, (34 Neb. 528, 534); *Electric Co. v. Electric Co.* (200 Pa. 516, 520-523, 526); *Wall v. Utah Copper Co.* (70 N. J. Eq. 17, 28 et seq.); *Stokes v. Continental Trust Co.* (186 N. Y. 285). Evidently this inherent equity was recognized in the statute and the resolution under which the new stock here in question was offered and issued.

The stockholder's right to take his part of the new shares therefore—assuming their intrinsic value to have exceeded the issuing price—was essentially analogous to a stock dividend. So far as the issuing price was concerned, payment of this was a condition precedent to participation, coupled with an opportunity to increase his capital investment. In either aspect, or both, the subscription right of itself constituted no gain, profit, or income taxable without apportionment under the sixteenth amendment. *Eisner v. Macomber* (252 U. S. 189) is conclusive to this effect.

But in that case it was recognized (p. 212) that a gain through sale of dividend stock at a profit was taxable as income, the same as a gain derived through sale of some of the original shares would be. In that as in other recent cases this court has interpreted "income" as including gains and profits derived through sale or conversion of capital assets, whether done by a dealer or trader, or casually by a nontrader, as by a trustee in the course of changing investments.—*Merchants' Loan & Trust Company v. Smietanka* (255 U. S. 509, 517-520.)

Hence the district court rightly held defendant in error liable to income tax as to so much of the proceeds of sale of the subscription rights as represented a realized profit over and above the cost to it of what was sold. How the gain should be computed is a matter of some contention by the government in this court; but it admits of little doubt. To treat the stockholder's right to the new shares as something new and independent of the old, and as if it actually cost nothing, leaving the entire proceeds of sale as gain, would ignore the essence of the matter, and the suggestion cannot be accepted. The district court proceeded correctly in treating the subscription rights as an increase inseparable from the old shares, not in the way of income but as capital; in treating the new shares if and when issued as indistinguishable

legally and in the market sense from the old; and in regarding the sale of the rights as a sale of a portion of a capital interest that included the old shares. What would have happened had defendant in error decided to accept the new shares and pay the issuing price instead of selling the rights is of no consequence; in that event there would have been no realized profit, hence no taxable income. What resulted or might have resulted to defendant in error's retained interest in the company, depending upon whether the purchaser exercised his right to subscribe or allowed it to lapse, or whether in the latter event the stock was sold by the directors is of speculative interest only. Defendant in error resorted to the market for the sale of a part of its capital interest, concededly sold at an advance over cost, and what the profit actually was is the sole concern here; not whether it might have been more or less, nor whether the purchaser disposed of the stock to advantage.

That a comparison of the cost at acquisition and the selling price is proper under section 202 (a) of the act (40 Stat. 1069), where, as here, the property was acquired and sold within the same taxing year, we understand to be conceded. Under the stipulation, the court below was warranted in finding \$710 per share to have been the fair market value of the old stock when turned over to the guardian, and treating this as its cost to the trust. It was proper to add to this the \$150 required to be paid to the company and treat the total as the cost to plaintiff of each two shares one of which was to pass to the purchaser. This in essence is the method adopted by the treasury department in the case of a sale of dividend stock, in regulations No. 45 (1920 ed., art. 1547), which reads:

ART. 1547. *Sale of stock received as dividend.*—Stock in a corporation received as a dividend does not constitute taxable income to a stockholder in such corporation, but any profit derived by the stockholder from the sale of such stock is taxable income to him. [Following *Eisner v. Macomber*, supra.] For the purpose of ascertaining the gain or loss derived from the sale of such stock, or from the sale of the stock with respect to which it is issued, the cost (used to include also, where required, the fair market value as of March 1, 1913), of both the old and new shares is to be determined in accordance with the following rules:

"(1) Where the stock issued as a dividend is all of substantially the same character or preference as the stock upon which the stock dividend is paid, the cost of each share of both the old and new stock will be the quotient of the cost, or fair market value as of March 1, 1913, if acquired prior to that date, of the old shares of stock divided by the total number of the old and new shares. * * *

That the averaging of cost might present more administrative difficulty in a case more complicated than the present, as where the old shares were acquired at different times, is not a sufficient ground for denying the soundness of the method itself.

Various suggestions, more or less ingenious, as to how the profit ought to be computed, made by counsel for defendant in error and by an amicus curiae, have been examined and found faulty for reasons unnecessary to be mentioned. Upon the whole, we are satisfied that the method adopted by the district court led to a correct result.

Judgment affirmed.

(T. D. 3367, July 10, 1922)

War excess profits tax.

Article 836, regulation No. 45 (1920 edition), and article 836, regulations No. 62, amended.

Article 836, regulations No. 45 (1920 edition), and article 836, regulations No. 62, are hereby amended to read as follows:

ART. 836. *Tangible property paid in; value in excess of par value of stock.*—The paid-in surplus allowed in any case is confined to the value definitely known or accurately ascertainable at the time the property is paid in. Evidence offered to support a claim for a paid-in surplus must be as of the date of the payment. It may consist among other things of (a) an appraisal of the property by disinterested authorities; (b) a certificate of the assessed value in the case of real estate, or (c) evidence of a market price in excess of the par value of the stock or shares. Opinion evidence, expert or otherwise, of the value of property as of a prior date will not be accepted. Retrospective appraisals submitted in support of a claim for a paid-in surplus will not be accepted in any case where other reasonably satisfactory evidence is available and in any case will be accepted only after rigid scrutiny and will be followed only to the extent to which their reasonableness is fully established. The property which was paid in is the basis of the appraisal, and the appraisal must reconcile the accounts so as to reflect accurately the actual value on the date as of which the appraisal is made and the depreciation sustained. Proper consideration must in all cases be given to depreciation and the expired and remaining serviceable life of the property must be shown. To be acceptable retrospective appraisals must show: (1) The history of the business and manner in which the information or data was acquired; (2) the manner in which the appraisals were constructed; (3) the inventory on the date of the appraisal in detail; (4) the date of acquisition of all items remaining in the inventory as of the date of appraisal; (5) the elimination from the inventory of all items acquired subsequent to the date as of which the appraisal is made and how this was effected (all items, the date of acquisition of which cannot be definitely determined, should be listed separately and all the facts bearing upon the date of acquisition given); (6) the replacement cost at the date as of which the appraisal is made of each item accepted as on hand on that date determined upon competent data, with a statement of the method employed in arriving at such cost (estimates and general statements will not be accepted); (7) the rate and total amount of depreciation as shown by the books; (8) the rate and total amount of depreciation taken upon each item included in the appraisal for the purposes of the appraisal (if other than normal rates of depreciation are used the reason therefor and the method of computing depreciation must be fully explained); (9) the actual cost when ascertainable of each item included in the appraisal; (10) the book value on the date as of which the appraisal is made of all the items included in the appraisal; and (11) a detailed statement of all plant facilities and additions, represented by capital expenditures previously written off, which were still in use on the date as of which the appraisal was made and all the depreciation actually sustained or accrued on such items. No claim will be allowed for paid-in surplus in any case in which the addition of value has been developed or ascertained subsequent to the date on which the property was paid in to

the corporation, or in respect of property which the stockholders or their agents on or shortly before the date of such payment acquired at a bargain price, as, for instance, at a receiver's sale. Generally, allowable claims under this article will arise out of transactions in which there has been no substantial change of beneficial interest in the property paid in to the corporation, and in all cases the proof of value must be clear and explicit.

Franklin K. Moyer

Franklin K. Moyer, member of the American Institute of Accountants, certified public accountant of Pennsylvania, died at Souderton, Pennsylvania on August 12th. Mr. Moyer was a partner of the firm of Moyer & Schectman, Philadelphia.

Mack E. Stewart

Mack E. Stewart, member of the American Institute of Accountants, died June 26th as a result of a gasoline explosion. Mr. Stewart had been a member of the institute since 1920 and was an active member of the profession in Oklahoma.

Frank H. Walker

Frank H. Walker, member of the American Institute of Accountants, died August 16, 1922. Funeral services were held at Amherst on August 18th. Mr. Walker had been associated for many years with the firm of Herbert F. French & Co. of Boston.

Oklahoma Society of Certified Public Accountants

At a meeting of the Oklahoma Society of Certified Public Accountants, held June 16, 1922, the following officers were elected: President, Homer C. Hammonds; treasurer, Mack E. Stewart; secretary, Carl L. Rice; auditors, Arthur Jones, Mack Porter; trustees, Robert E. Garnett, Hugh M. Rush and William C. Beck.

Arthur E. Chandler and Howard E. Murray announce the admission to partnership of Floyd Chilton, under the firm name of Chandler, Murray & Chilton, with offices at 816-818 Second National building, Akron, Ohio.

William Bryden & Co. announce change in name to Bryden & Fauble and the removal of their offices to 638 Securities building, Omaha, Nebraska.

Patterson, Teele & Dennis announce the admission of Harold Burton Hart to partnership as of July 18, 1922.

Seward, Stone & Monde announce the opening of an office in the Aeolian building, 33 West 42nd street, New York.

Students' Department

EDITED BY H. A. FINNEY

INSTITUTE EXAMINATIONS

(NOTE—The fact that these answers appear in THE JOURNAL OF ACCOUNTANCY should not lead the reader to assume that they are the official solutions of the American Institute of Accountants. They merely represent the personal opinion of the editor of the *Students' Department*.)

AUDITING

May 18, 1922, 9 A. M. to 12:30 P. M.

Answer all questions.

No. 1 (10 points):

In listing the balances from creditors' ledger (assumed to be in agreement with controlling account) you find several debit balances. State three causes which may account for these. How would you treat cases arising from each cause?

Answer: First, goods may have been returned to a creditor, or an allowance may have been claimed and charged to his account after the account was settled. The debit should be verified by inspection of a credit memorandum or by correspondence received from the creditor and on file. Mere evidence of shipment of the goods is not sufficient, for such evidence would not show that the creditor has granted or will grant the credit.

Second, advances or deposits may have been made on purchase commitments. These should be verified by inspection of contracts or correspondence on file.

Third, the creditor may have purchased goods which were charged to his account in the subsidiary creditors' ledger instead of to an account with him in the subsidiary accounts-receivable ledger. The sale and consequent debit would be verified by an examination of invoices and shipping records.

The question now arises as to how these debit balances should be dealt with in the books and on the balance-sheet. Debit balances arising from the first cause may be set out on the asset side of the balance-sheet as "debit balances of accounts payable," but there is no necessity of doing so unless they are of considerable amount.

Advances and deposits should be shown as such on the asset side of the balance-sheet, and it would be better to carry them as assets in the general ledger than as debits to personal accounts in the subsidiary ledger.

The treatment of debit balances arising from the third cause would depend on the conditions of each case. Unless an understanding had been reached with the creditor which provided for an offset of the account receivable and the account payable, there should be open balances in both the accounts-payable and accounts-receivable subsidiary ledgers. If there has been no such agreement, the balance-sheet should include the account payable and the account receivable rather than the net amount. If an offset agree-

ment has been reached, the debit balance in the account-payable ledger should be transferred to an account in the subsidiary accounts-receivable ledger, and it should be included among the accounts receivable in the balance-sheet.

No. 2 (15 points):

(a) Give particulars of the nature of the examination you would make of inventories submitted to you as representing merchandise and the operating supplies on hand at the date of the balance-sheet of a retail grocery business operating a chain of stores.

(b) The company's sales are on a "cash" basis. The balance-sheet shows that the only assets are inventories and cash, the inventories representing 90% of the total assets. Would that condition suggest to you the need for any special consideration as to the extent of the auditor's examination of the inventories?

Answer: (a) The verification of an inventory involves a consideration of prices, extensions and footings and quantities. Prices would be verified by examination of invoices. Extensions and footings would be verified in the usual manner, in total or by tests of larger items. As to quantities, it would probably be impossible to make any physical inspection of the goods because of the elapsed time between the balance-sheet date and the audit date and because the inventories are in a number of different places. Various tests could be made which would probably disclose irregularities.

In the first place, the quantities appearing in the inventories could be compared with the deliveries from the central warehouses to see whether the quantities are reasonable or not. For instance, the records at the central office may show that weekly deliveries of about one hundred units of a certain article have been made to one store throughout the year. This gives a good indication of the volume of business done in this particular article, and the quantity of stock which should be carried. If the inventory shows four hundred or five hundred units of this article, there might be reason to believe that the inventory is inflated.

In the second place, comparisons should be made of the various stores. For example, if all the stores showed about the same condition as that described in the preceding paragraph there would be no reason for doubting the accuracy of the inventory, but if the inventories of all of the other stores showed quantities of this particular item equal to about a week's deliveries to the store, there would be reason to be suspicious of the inventory which showed quantities on hand equal to the receipts for four or five weeks.

In the third place, an adaptation of the gross-profit method may be used. Since the stores are all dealing in the same classes of goods, the rates of gross profit should be fairly uniform among all the stores. Any serious overstatement of the inventory at one store might cause enough of a variation in its rate of gross profit to attract attention.

In the fourth place, many businesses running chain stores bill the goods at retail prices, so that billings less income from sales should represent the inventory on hand at selling prices. But this method of verifying the inventory is subject to two objections: in the first place, the system of accounting will have to be very highly developed to take care of mark-ups and mark-downs in a thoroughly satisfactory manner and maintain a balance repre-

senting the present selling price of the goods on hand at the store; in the second place, an overstatement of the inventory to offset unreported cash sales would not be detected unless periodical tests were made by checking the goods actually on hand.

Before making the tests suggested above, it would of course be necessary to separate the merchandise and supplies inventories.

(b) Since the sales are on a cash basis, any understatement of sales for the purpose of concealing a cash shortage would be offset by overstatements in the inventories. This would be particularly true in stores where goods are billed at selling prices, with the intention of maintaining a check on inventories, sales and cash, for in such cases the cash receipts and the inventories at selling price would have to equal the billed price of shipments after adjustments for mark-downs and mark-ups. For this reason the verification of the inventories would be especially important because of the relation of the inventories not only to profits, but also to cash.

No. 3 (10 points) :

State in detail how you would audit and verify the notes receivable of a large trading corporation with several affiliated concerns, giving due attention to collateral, notes discounted, makers, etc.

Answer: In the first place, a distinction should be made between notes received from customers and notes received from affiliated companies, because notes of the first class are presumably current assets to be collected in accordance with the credit customs of the trade, while notes of the second class are likely to be permanent advances to the affiliated companies.

All notes on hand should be examined and checked against the notes-receivable register, comparing the register and the notes as to maker, time, interest rate, collateral and face. The open items of the register should then be totaled and compared with the balance of the notes-receivable account. A schedule should be made up showing these facts if there is no notes-receivable register, and may be made in any case.

The register should contain information of the collateral received with the notes; and this collateral should be examined to see that none of it has been improperly sold or used for unauthorized purposes.

Any notes received otherwise than in the course of trade should be set out as a separate item in the balance-sheet, so that the balance-sheet will show trade notes receivable as distinguished from all others. Any overdue notes should be charged back to the customers' accounts. The notes should be valued in the light of any available information as to note losses in the past and the credit reputation of the various makers.

If the accounts receivable are verified by circularizing, a similar verification may be made of the balance due from debtors on notes, and such verification would be particularly desirable in case of overdue and demand notes, as total or part payments may have been made on these notes without having been recorded.

Bankers and note brokers who have discounted the client's paper should be asked for a statement of the discounted paper held. Discounted trade notes should be separated from discounted notes received from affiliated

companies, because, while the former represent only contingent liabilities, the latter will be shown as actual liabilities if a consolidated balance-sheet is prepared.

No. 4 (10 points):

The T. N. T. Corporation is organized October 1, 1921, to exploit a new and untried patent. On that date it issues its entire capital stock of no par value, 100 shares for cash at \$100 a share, and 900 shares for the patent, the latter being expressly stated in the authorizing resolution as "having no cash value." Its fiscal year is fixed as beginning January 1st, and on December 31, 1921, the treasurer makes up the corporation's first income-tax return based on the following

BALANCE-SHEET

Cash	\$1,000	capital stock (1,000 shares)	\$100,000
Patent	90,000		
Plant and equipment.....	7,000		
Expenses to date.....	2,000		
	<u>\$100,000</u>		<u>\$100,000</u>

Across the face of schedule A of the income-tax return the treasurer writes: "No business done as yet so there is no net income to report." In schedule B he writes:

"Cash paid in.....	\$10,000
"Patent (25% of stock issued, said stock valued at same amount as that sold for cash on same date).....	22,500
	<u>\$32,500</u>

He submits this return and balance-sheet to you for your criticisms. What are they? Give reasons.

Answer: There are several points here which should be called to the treasurer's attention. First, from an accounting standpoint, the capital-stock account should be credited only with the amounts paid for the stock, since it is no-par-value stock. If the patents really had no value there should be no patents account, and the capital stock should be carried at \$10,000.

Second, from the tax standpoint, the fact that the patents were stated to have no cash value will not prevent the corporation from establishing the fact that they have a cash value if there is evidence to support such a contention.

Third, the 25% limitation applies to the total stock outstanding at the beginning of the taxable year, and not to the stock issued for the patent.

Fourth, and most important, the company has made no profit during the year 1921 and it therefore has no tax to pay, regardless of the amount of the invested capital. And as 1921 was the last year in which the amount of invested capital affected the tax on corporations, the valuation of the patent has no bearing on taxes.

No. 5 (8 points):

To what extent is it an auditor's duty to concern himself with the validity of transactions coming under his notice?

Answer: The answer to this question depends upon what is meant by validity. The word valid is defined as "sufficiently supported by actual fact," and also "good or sufficient in point of law."

The first definition of valid can hardly have been meant, for since transactions are facts it is difficult to see how they would be supported by facts. If the word entries had been used instead of transactions, the question would mean, Should the auditor determine whether the entries are supported by facts? There is no question that he should.

But since the word transaction is used, the question must mean, Should the auditor concern himself with the legality of the transactions? In other words, if he is convinced that the management of the corporation has committed acts *ultra vires*, such as engaging in a business not authorized by the charter or paying dividends out of capital or without a formal declaration of dividends, is it his duty to advise his client of this fact? I should say that it is his duty, and that advice of this kind is along the modern line which auditors are following in rendering service as general business advisors. Advice to clients is a different matter, however, from publishing such facts in a report.

No. 6 (10 points):

In making up an income-tax return for a client an auditor makes a serious clerical error in calculations. The client files the return as made and pays the tax. Two years later the treasury department calls attention to the error, and it appears that the client has paid a larger tax than he should have paid. What is the duty of the auditor in the case?

Answer: This seems to be a question of professional ethics and business expediency rather than of accounting principles. I should say that the auditor should perform without compensation whatever clerical work was necessitated by his error and compensate his client to his satisfaction, within reasonable limits, for any loss resulting from the tying up of capital by the payment of excess taxes.

No. 7 (10 points):

A corporation has insured the life of its president for its own benefit and is carrying the amount of premiums paid on its balance-sheet. What position should an auditor take in regard to these premiums?

Answer: The corporation should carry as an asset only the cash-surrender value of the insurance policy. The premiums paid during the year minus the increase in the cash-surrender value accrued during the year should be charged off as an expense.

No. 8 (7 points):

Explain the points of difference in procedure in a detailed audit of earnings and expenses and in a balance-sheet audit.

Answer: The detailed audit involves a fairly exhaustive checking of the entries in the various books of original entry against vouchers of all sorts to see that these entries are adequately supported by documentary evidence; it also involves considerable footing of books of original entry and proof of posting.

In a balance-sheet audit, the income is verified by various tests to see whether the transactions are in general recorded in accordance with correct principles. For instance, are consignments recorded as such or as sales? Is a proper distinction maintained between capital and revenue expenditures? Is there provision for depreciation and bad debts? Is proper recognition given to accrued and deferred items? Determining such facts as these

requires only a general inspection of the accounting system and sufficient tests and examination of vouchers to satisfy the auditor that a proper effort is being made to apply correct principles.

No. 9 (10 points):

"Net income" of individuals is defined in the income-tax law of 1921 as "the gross income as defined in section 213 less the deductions allowed by section 214." Name (in brief titles ignoring provisos and exceptions) six items of allowable deductions. What are some unallowable expenses?

Answer: Six allowable deductions:

- Business expenses.
- Interest paid or accrued.
- Taxes.
- Depreciation and depletion.
- Bad debts.
- Contributions.

Some unallowable expenses:

- Personal and living expenses.
- Special assessments for local benefits.
- Life-insurance premiums.

No. 10 (10 points):

The town of X erects a school building from the proceeds of bonds issued for the purpose. The building is estimated to last twenty years. The bonds also mature in twenty years and contain a sinking-fund clause to provide the funds for their payment at maturity. The school board makes no provision for depreciation on the building in the annual tax rate, and a controversy arises in the town as to whether or not such provision should be made. Discuss briefly both sides of this question.

Answer: It is important to distinguish between the relation of depreciation to the tax rate and the relation of depreciation to the revenue statement. The statement of the school district ought to show the depreciation of the school building as one of the expenses of operating the school system, but it is not necessary to include in the tax rate a provision for sinking-fund payments and also a provision for depreciation, unless the taxpayers wish to tax themselves during the next twenty years to pay for the school building which they are now using as well as for the one which they expect to have to build twenty years hence.

COMMERCIAL LAW *

May 19, 1922, 9 A. M. to 12 30 P. M.

NEGOTIABLE INSTRUMENTS

Answer three of the following four questions:

No. 1 (10 points):

To what requirements must an instrument conform to render it negotiable?

Answer: These requirements are set out in section 1 of the negotiable instruments law as follows:

"(1) It must be in writing and signed by the maker or drawer.

* Answered by John C. Teevan, instructor in business law, Northwestern University School of Commerce.

"(2) It must contain an unconditional promise or order to pay a sum certain in money.

"(3) It must be payable on demand or at a fixed or determinable future time.

"(4) It must be payable to the order of a specified person or to bearer; and

"(5) Where the instrument is addressed to a drawee, he must be named or otherwise indicated therein with reasonable certainty."

No. 2 (10 points) :

How is a person secondarily liable on a negotiable instrument discharged from liability?

Answer: Section 120 of the negotiable instruments law provides as follows:

"A person secondarily liable on the instrument is discharged:

"(1) By an act which discharges the instrument.

"(2) By the intentional cancellation of his signature by the holder.

"(3) By the discharge of a prior party.

"(4) By a valid tender of payment made by a prior party.

"(5) By a release of the principal debtor, unless the holder's right of recourse against the party secondarily liable is expressly reserved.

"(6) By any agreement binding upon the holder to extend the time of payment, or to postpone the holder's right to enforce the instrument, unless made with the assent of the party secondarily liable, or unless the right of recourse against such party is expressly reserved."

A party secondarily liable is also discharged from liability by failure of the holder to take the proper steps to hold such party; such steps being presentment for payment to the party primarily liable at the proper time and place or proper presentment for acceptance, protest in case of foreign bills of exchange and proper notice of dishonor for non-payment or non-acceptance as the case may be.

Discharge of a party secondarily liable is also possible, under section 122 of the act, where the holder expressly renounces his rights against any party either by so stating in writing or by delivering the instrument.

No. 3 (10 points) :

What is the effect of a material alteration of a negotiable instrument and what constitutes a material alteration?

Answer: The effect of such alteration is to release all parties to the instrument who did not authorize or assent to such alteration; but an innocent purchaser for value may enforce the instrument as it was before the alteration. Section 124 of the negotiable instruments law provides as follows:

"Where a negotiable instrument is materially altered without the assent of all parties liable thereon, it is avoided except as against a party who has himself made, authorized or assented to the alteration and subsequent endorers.

"But when an instrument has been materially altered and is in the hands of a holder in due course, not a party to the alteration, he may enforce payment thereof according to its original tenor."

As to what constitutes a material alteration, section 125 of the act provides that

"Any alteration which changes (1) the date; (2) the sum payable, either for principal or interest; (3) the time or place of payment; (4) the number or the relations of the parties; (5) the medium or currency in which payment is to be made; or which adds a place of payment, where no place of payment is specified, or any other change or addition which alters the effect of the instrument in any respect is a material alteration."

No. 4 (10 points):

Rowe, private secretary for Foster, brought to Foster a cheque for signature payable to cash. The cheque was made out in figures for \$50.00, but no words were inserted in the space left for writing. Rowe raised the cheque to \$500.00, which Foster's bank paid. Was the bank liable?

Answer: The bank is not liable. It should be noted, first, that this cheque being payable to cash was therefore payable to bearer; second, that it was delivered by the maker, Foster, to Rowe; third, that it was an incomplete instrument. From the wording of the question it must be assumed that the amount in figures, \$50.00, was altered by Rowe to read \$500.00, and that Rowe also inserted the amount, \$500.00, in words in the space left for writing. Technically, the marginal figures on a negotiable instrument are not part of the instrument, but are merely a memorandum of or convenient reference to the amount. Hence the act of raising \$50.00 to \$500.00 did not constitute a material alteration or a forgery. Section 14 of the negotiable instruments law provides that where an instrument is wanting in any material particular, the person in possession thereof has a prima facie authority to complete it by filling up the blanks therein. This cheque, therefore, was a valid negotiable instrument. The courts have given two reasons why the maker of such an instrument must bear the loss. One is that the maker of an instrument by leaving a blank therein impliedly authorizes the person to whom it is delivered to fill in the blank. The other reason is the negligence of the maker in executing an instrument containing unfilled blanks.

CONTRACTS

Answer two of the following three questions:

No. 5 (10 points):

Define (a) a bailment, (b) a conditional sale.

Answer: (a) A bailment consists in a transfer by one person (the bailor) to another (the bailee) or a holding by such bailee of personal property under a contract or a legal duty, pursuant to which the bailee is obligated to return the same property in its original or altered condition to the bailor or on the order of the bailor to deliver it to a third person. Generally a bailment exists by reason of delivery by the bailor to the bailee under a contract express or implied. Delivery or contract, however, is not essential to the existence of a bailment, as the finder or thief of personal property is technically a bailee.

(b) A conditional sale is one in which the possession of the goods passes from the seller to the buyer, the vesting of title to the goods in the buyer or the reversion of title in the seller depending upon the occurrence or non-occurrence of some condition. Such conditions may be precedent or subsequent. A sale upon condition precedent exists where the title in the goods is not to vest in the buyer until he has performed or fulfilled some condition. A sale on the instalment plan and a sale on approval are both sales upon condition precedent. In a sale upon condition subsequent, the title passes at once to the buyer, subject to being divested on the performance or happening of some specified condition. A "sale or return" transaction is an illustration, as where goods are paid for and delivered on the condition that the buyer may return the goods within a specified time, if he so desires, and receive his money.

No. 6 (10 points) :

A, in Chicago, sold certain goods to B in Boston. The goods were shipped to B by express. After shipment, and while the goods were in the possession of the express company, A ascertained that B was insolvent and unable to pay for his purchase. A notified the agent of the express company at Boston, in whose custody the goods were, to withhold delivery to B and to return the goods to A. The goods were, however, delivered to B upon his payment of the express charges. A sued the express company for conversion. Could he recover?

Answer: Under what is known as the seller's right of stoppage in transitu, A can recover. Under sections 57 to 59, inclusive, of the uniform sales act, when the seller learns that either at the time of the sale or subsequent thereto and while the goods are in transit, that is, in the possession of a carrier to whom they were delivered for transmission to the buyer, the buyer was or has become insolvent, the seller may exercise the aforesaid right by obtaining actual possession of the goods or by giving notice to the carrier. He is then entitled to the same rights in regard to the goods that he would have had if he had never parted with possession. Goods are in transit from the time when they are delivered to a carrier for transmission to the buyer until the buyer takes delivery of them from such carrier. In the present case, A having learned after shipment of the goods that B was insolvent, and the goods still being in transit, and A having given notice to the express company while the goods were in transit, the company delivered the goods to B at its peril and is liable to A for damages.

No. 7 (10 points) :

What is meant (a) by the words "substantial performance" as applied to contracts; (b) by the term "quantum meruit"?

Answer: (a) The words "substantial performance" as applied to contracts indicate an exception to the general rule that the performance of a contract must be in strict compliance with all the terms thereof. By substantial performance is meant that the party has made a bona-fide effort to live up to all terms of the contract, that there has been no wilful or intentional departure from such terms and that the deviations or defects in performance are of a minor nature only.

As above indicated, the strict common-law rule requires literal compliance with all the terms of the contract, failing which the party cannot recover—or if he is allowed to recover it is on an implied contract and not on the express contract. To apply the strict rule in every case would frequently work a hardship; hence where the terms of the contract involve numerous and complex details (building contracts being a notable example), the courts will allow recovery if the plaintiff can prove substantial performance, a deduction from the contract price being allowed to equalize matters. In courts of equity substantial performance is sufficient, unless the contract expressly provided for strict performance. As to the time of performance, the common-law rule is that time is of the essence of the contract—that is, delivery or performance must be on the date specified. The rule in equity has been indicated. If the contract provides for performance to the “satisfaction” of a party, the rule is that such party is the sole judge as to such satisfaction, where the element of personal taste or fancy is involved, as in the making of a suit of clothes, a portrait, a statue, etc. Where such elements are not involved, that performance which would satisfy a reasonable requirement is held sufficient.

(b) Quantum meruit is a technical term used in pleading and means “as much as he deserved.” The action of *assumpsit* on a quantum meruit is proper where one person has employed another to work for him without any agreement as to compensation, and where, after the work has been performed, the employer refuses to pay. Such an action is brought on the implied promise of the employer to pay the employee reasonable value of his service or as much as he reasonably deserves. Where the rate or amount of compensation was agreed upon, the action would be on the express contract and not on a quantum meruit.

PARTNERSHIPS

Answer one of the following two questions:

No. 8 (10 points):

X acquired the interest of A in the copartnership of A and B by purchase at a sale under execution issued on a judgment against A individually. Subsequently A and B gave a chattel mortgage on firm property to Y, a firm creditor. Were X's rights in the property superior to Y's or vice versa?

Answer: When A's interest was sold to satisfy X's judgment, A ceased to be a partner; in other words, the sale dissolved the partnership. A therefore had no title or interest in the firm property and hence could convey none to Y either by chattel mortgage or in any other way. B's duties, the partnership being dissolved, were to liquidate the assets, pay off the creditors and wind up the business. Such duties do not include the execution of chattel mortgages on firm property. For these reasons the chattel mortgage to Y was null and void, and conveyed no right or interest whatever in the firm property to Y. Hence as far as the chattel mortgage is concerned, X's rights are superior to those of Y.

Y, however, is a firm creditor and as such has superior rights in the firm property to X. The purchaser of the partner's interest in the partnership gets such partner's pro rata share in the firm assets after all firm

debts and liabilities have been discharged and an accounting has been made between the parties. A's interest, therefore, could not be ascertained until Y, together with all the other firm creditors, had been paid. Hence X's rights in the firm property are subject and inferior to those of Y.

No. 9 (10 points):

What is a limited partnership?

Answer: A limited partnership is defined by the uniform limited partnership act as "a partnership formed by two or more persons under the provisions of section 2, having as members one or more general partners and one or more limited partners." Such partnerships are purely statutory and are unknown to the common law. Under the common law all partners are general partners—that is, are subject to unlimited liability for partnership obligations. Limited or special partners are liable for firm obligations only to the extent of the capital they have invested. Section 2 of said act requires persons about to form a limited partnership to sign and swear to a certificate including among other things a statement of the character of the business, firm name, names of partners, amount of contributions, duration of the business, etc. Such certificate must be filed for public record and serves as notice of the limited liability of the special partners. It should be noted that a limited partnership must include at least one general partner whose liability is unlimited. Limited partnerships are not very numerous. Incorporation provides for limited liability with equal if not greater effectiveness, besides having other advantages over a limited partnership.

CORPORATIONS

Answer both the following questions:

No. 10 (10 points):

A corporation is formed in Delaware which is empowered by its charter or certificate of incorporation to do business in all states of the United States. Specify what steps in general should be taken by the corporation before operating in states other than Delaware and what would be the result, if any, of failure to take such steps?

Answer: In all the states other than Delaware, this corporation would be considered as a foreign corporation, and prior to doing business in any other state it would have to comply with the foreign-corporation laws thereof. While these laws are not uniform, the steps to be taken by this corporation would include the filing of a certified copy of its charter with the secretary of state; the payment of certain fees; the filing of a sworn statement setting forth the name of the corporation and its principal place of business, the names of other states in which it is qualified to do business, the character of business intended to be carried on, an estimate of corporate property to be used within the state, the name and address of a resident agent of the corporation upon whom service of summons and other legal process may at all times be made, and the names and addresses of its officers and directors.

If this corporation proceeded to do business in another state without first complying with the foreign-corporation laws of such state, it would

render itself liable to certain penalties or disabilities. These usually include the imposition of a fine, the forfeiture of a right to maintain suits on contracts or other rights and exclusion from the state.

No. 11 (10 points) :

Is there any distinction between the "capital" and the "capital stock" of a corporation? And if so explain such distinction.

Answer: Yes, the law recognizes a marked distinction. By the capital stock of a corporation is meant the total amount fixed by the charter or certificate of incorporation paid in or to be paid in as the fund with which the corporation is to do business. It remains a fixed sum in amount and does not vary, except by amendment to the charter, when it again becomes fixed. It is true that the capital stock may fall below the amount as fixed by the charter, but up to such amount the corporate property is to be regarded as capital stock. If there is an excess or surplus, such surplus is not legally part of the capital stock. It may be disbursed in the form of dividends, which is not true of capital stock.

By the capital of a corporation is meant simply the money and other property owned by the corporation at any given time. Capital may be the same as capital stock or, as is usually the case, may be greater or less. Unlike capital stock the corporate capital may vary from time to time.

BANKRUPTCY

Answer the following question:

No. 12 (10 points) :

What is the difference between a receiver in bankruptcy and a trustee in bankruptcy?

Answer: A receiver in bankruptcy is an officer appointed by the court to take temporary charge of the bankrupt's property until a trustee is elected. A trustee is an officer elected by the creditors of the bankrupt at their first meeting. He takes title to the bankrupt's estate, liquidates and administers the estate, and pays dividends to creditors. On payment of the final dividend, he prepares his report and account, on the approval of which he is formally discharged. The appointment, classification, duties, etc., of trustees are described in sections 44 to 50 inclusive of the federal bankruptcy act.

FEDERAL INCOME TAX

Answer the following question:

No. 13 (10 points) :

Explain the meaning of depreciation and of depletion as used in the federal income-tax act.

Answer: Taking depreciation first, this term appears in the revenue act of 1921 in section 214 (a) (10) and in section 234 (a) (9), the former having to do with deductions allowed to individuals and the latter with deductions allowed to corporations. Both clauses are the same and read as follows:

"In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted."

Hence the term depreciation as used in the act has a special meaning, applying only to improvements related to the exploitation of natural resources. However, depreciation is allowed as a deduction in other business, as provided for in section 214 (a) (8) and section 234 (a) (7), in the following language:

"A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence."

This clause is itself an explanation of the meaning of depreciation in the act, although the word itself is not used in the clause.

The term "depletion," as used in the act, is the deduction allowed for the exhaustion and wasting of minerals, oil, timber and other natural resources.

PROFITS ON CANCELED SALES

Editor, Students' Department:

SIR: Will you favor me with an answer to the following question:

A agrees to purchase a tract of land from B for \$500,000.00 on January 1, 1921, paying \$100,000.00 at that time and giving four notes of \$100,000.00 each at 6%, maturing in one, two, three and four years. On June 30, 1921, they cancel the contract and notes by mutual agreement; B retains the original \$100,000.00 as a forfeited option payment, but in case he sells the land again will return to A any excess of the sale price over \$500,000.00, but not exceeding \$100,000.00, less an amount equal to interest on \$400,000.00 at 6% from January 1, 1921, to the date of re-sale. The land not being resold as yet, what profit (if any) should B take into account on his books at June 30, 1921, and at December 31, 1921, and under what caption should he enter it in his profit-and-loss statement?

B carries the land on his books at a very low figure. He may sell again at any time or price.

Yours truly,
A. D. A.

San Francisco, California.

It appears that B has made a profit of \$100,000.00, minus any expense connected with the sale to B and the forfeiture. At the present time B has his land and \$100,000.00. It is true that he may have to return a part of the \$100,000.00, but this will happen only if he sells the land for more than \$500,000.00. That means that he is bound to make his \$100,000.00 profit. If he does not re-sell the land he will keep the \$100,000.00. If he does re-sell, he will make as a profit the difference between the original cost of the land and \$500,000.00, and since he bought at a "very low price" this profit will apparently be more than \$100,000.00. Therefore I think that his profit-and-loss statement at June 30th should show miscellaneous income of \$100,000.00.

It appears that the interest feature is not operative unless B re-sells. There is no unconditional promise on A's part to pay B interest. Hence there does not seem to be any justification for accruing interest on B's books. That would mean that there would be no additional income to show in the statement at December 31st.

TAXES AND BONUS

Editor, Students' Department:

SIR: Regarding the formulas which have appeared in THE JOURNAL OF ACCOUNTANCY from time to time for computing commission after deducting federal taxes, in view of the change in the law affecting 1921 and 1922, particularly where the fiscal year ends in 1922, it seems now very difficult to determine the proper amount of commission after allowing for these taxes. The writer has a complex problem in this respect and he suggests that if you would have this problem worked out and published, it would no doubt be of assistance to him and also to other subscribers who have a similar difficulty before them. The following is an outline of the points of the problem:

A bonus of 10% of the net profit is to be allowed to an employee. This bonus is to be based on the profits according to the books, including interest on obligations of the United States, dividends on personal-service-corporation stock, profits on dealings in the corporation's own stock, with deductions for amortization of organization expense and other items which enter into schedule L—reconciliation of net income and analysis of changes in surplus.

The profits according to the books are \$49,700.00, and the profits subject to tax (before deduction of bonus) are \$49,900.00. The bonus is not to be considered an expense in computing the net profit subject to bonus.

The invested capital is \$800,000.00; hence there is no excess-profits tax as the profit is less than 20% of the invested capital. The taxable profit even after the commission is deducted is over \$25,250.00, so there is no \$2,000.00 exemption from the normal tax. The fiscal year ends on February 28th; therefore the tax would be computed as follows: 10/12 at 1921 rates and 2/12 at 1922 rates.

You will observe that there are a great many unusual conditions that enter into this particular example, and it would be of some satisfaction to the writer to see it worked out in a clear and intelligible form so that the average accountant could work out and prove the result.

Respectfully yours,

A. S. S.

Boston, Massachusetts.

Solution: The tax is composed of two elements:

At 1921 rates: $\frac{5}{6}$ of 10% of the net profit, or $\frac{.50}{6}$ of the net profit.

At 1922 rates: $\frac{1}{6}$ of $12\frac{1}{2}\%$ of the net profit, or $\frac{.125}{6}$ of the net profit.

Then the total tax is $\frac{.50}{6} + \frac{.125}{6}$ or $\frac{.625}{6}$ of the net profit.

This simple computation gives us a single rate which overcomes any difficulties arising from the fact that the fiscal year covers portions of two years with different tax rates.

Expressing the tax by the letter T, and the bonus by the letter B, we have

$$B = \frac{\$49,700 - T}{10}$$

$$\text{and } T = \frac{.625}{6} (\$49,900 - B)$$

Re-stating the second equation by eliminating the symbol B and replacing it by the value of B as shown in the first equation, we have

$$T = \frac{.625}{6} (\$49,900 - \frac{\$49,700 - T}{10})$$

The various steps in the process of solving for T are given below:

$$T = \frac{.625}{6} [\$49,900 - (\$4,970 - .10 T)]$$

$$T = \frac{.625}{6} (\$49,900 - \$4,970 + .10 T)$$

$$T = \frac{.625}{6} (\$44,930 + .10 T)$$

$$T = \$4,680.21 + .0104166 T$$

$$.9895834 T = \$4,680.21$$

$$T = \$4,729.48$$

$$\text{Then } B = \frac{\$49,700 - \$4,729.48}{10}$$

$$B = \$44,970.52 \div 10$$

$$B = \$4,497.05$$

Proof:

Net taxable profit, before bonus.....	\$ 49,900.00
Deduct bonus	4,497.05

Net taxable profit.....	\$ 45,402.95
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Tax:

At 1921 rates: 5/6 of 10% of \$45,402.95.....	\$ 3,783.58
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At 1922 rates: 1/6 of 12½% of \$45,402.95.....	945.90
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Total tax—as above.....	\$ 4,729.48
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Collins, Morris, Keller & Co. and Theodore J. Witting announce the consolidation of their practices under the firm name of Collins, Morris, Keller & Co., with offices in the Foster building, Denver, Colorado.

Barrow, Wade, Guthrie & Co. announce the removal of their offices to 120 Broadway, New York.

Terminology Department

CONDUCTED BY THE SPECIAL COMMITTEE ON ACCOUNTING TERMINOLOGY
OF THE AMERICAN INSTITUTE OF ACCOUNTANTS

The committee on terminology presents in this issue of THE JOURNAL OF ACCOUNTANCY definitions of:

Depreciation
Depletion
Amortization
Appreciation
Obsolescence
Inadequacy

The first thought of the committee was to publish definitions of these words by various authorities and at a later date to formulate its definitions based upon the consensus of opinion as reflected by the comments and criticisms received. This course would only delay final results and the committee therefore decided to formulate definitions at this time and, as far as possible, to establish definite lines of demarcation between the words discussed. These definitions are, of course, subject to revision and amplification after all communications on the subject have been duly considered.

Depreciation:

The basic idea conveyed by this word is indicated by its derivation—*de*, down, and *pretium*, price—that is, a reduction in price or value.

Depreciation is loss in physical or functional value of physical property other than wasting assets due primarily and chiefly to ordinary wear and tear which has occurred *theoretically* in the past and which is not offset by adequate repairs and/or replacements. Obsolescence and inadequacy are included by regulatory bodies and taxing authorities as contributory causes, but it is more in accordance with fact to treat these two elements as separate from ordinary wear and tear on the ground that the loss incident thereto does not usually accrue and cannot be foreseen with any degree of accuracy. Depreciation, however determined, is at best only an *estimate*.

Unfortunately for the possibility of clear accounting terminology, depreciation is also commonly used to denote shrinkage in the conversion value of property (securities, real estate, etc.) or mediums of exchange (coins, bullion or paper currency) and indicates in this sense a temporary or permanent loss arising from economic or related causes.

It is of interest that in some lines of business, e. g., long-distance telephone service, extraordinary casualties due to the action of the elements are regular visitants and are provided for by a so-called reserve for extraordinary depreciation which may be estimated in advance quite closely, based upon experience extending over a period of years.

Depletion:

Depletion conveys the idea of emptying, reducing or exhausting the source of supply and is used chiefly

(a) In reference to natural resources, such as mines or timber-lands, indicating loss in physical value properly commensurate with the removal of the product, and less frequently

(b) In reference to financial strength, as, for example, the "depletion of the treasury."

Depletion differs from physical depreciation in that the former implies the removal of an asset for consumption purposes, whereas the latter indicates a reduction in value caused by use or neglect.

The word is seldom found in the writings of British accountants, as is indicated by its omission from various word-books edited by Damson, Lisle, Pixley and Porter, and is usually interpreted by these writers in the sense of "expired capital outlay," forming one of the elements of depreciation.

Amortization:

The basic idea suggested by this word is that of reducing, redeeming or liquidating the amount of an account already in existence.

In finance and accounting this word means the gradual extinguishment of an asset, a liability or a nominal account by prorating the amount thereof over the period during which it will exist or during which its benefit will be realized.

Amortization is caused by, and the computations are based upon, efflux of time or units of production, the life of a right or obligation or the loss of possession or use being the governing factors, e. g., amortization of a patent or of debt discount and expense or of a bonus paid for a lease or of the value of machinery, buildings, etc., on leasehold property which revert to the landlord upon expiration of a lease, or of the value of mine equipment whose useful life is known to exceed the productive life of the mine and is necessarily to be abandoned upon ceasing operations.

Amortization is also used to denote the gradual extinguishment of a debt by means of a sinking fund.

The distinction between amortization and depreciation is clearly brought out in the case of a tributary asset such as mine shafting, where the life of the mine is estimated as less than that of the shafting. In such a case the shafting should be *amortized* over the life of the mine, and not *depreciated* on the basis of physical deterioration. If the mine product were no longer salable *obsolescence* would be the proper designation for the loss in value of the shafting.

In law, amortization has an additional meaning, namely, the act of alienating lands or tenements to a corporation in mortmain. In old French law this could only be done by permission of the king and there was involved the payment of a tax by the corporation so that in time the word was often used to signify this tax.

Appreciation:

This word indicates an increased conversion value of property (securities, real estate, etc.) or mediums of exchange (coins, bullion or paper currency) due to economic or related causes which may prove to be either temporary or permanent.

Appreciation is the antonym of depreciation in so far as the latter is used to denote shrinkage in conversion value.

Obsolescence:

The basic idea conveyed by this word is that of becoming out of date or falling into disuse.

It is usually applied to plant and equipment which although in good physical condition have become old fashioned through progress of invention or advance in the arts, results being achieved more efficiently and/or at less cost under new methods.

Obsolescence may also be caused by the cessation of a demand for the particular articles for the production of which a plant or unit thereof was constructed or installed. This element of loss would be eliminated if the plant or unit could readily be converted to other use.

Regulatory bodies and taxing authorities provide that obsolescence is to be considered in conjunction with wear and tear and inadequacy in arriving at depreciation rates, but in fact obsolescence, except in certain industries, rarely accrues and a plant unit is usually up-to-date until it actually becomes obsolete. Any provision for obsolescence is, therefore, in most cases, a mere segregation of surplus. Coming events occasionally but not usually cast shadows before.

Inadequacy:

The basic meaning of this word is lack of size or of capacity in its broadest sense.

The word usually refers to plant and equipment which, although in good physical condition, is inadequate to carry the productive load required of it. This element of loss would be eliminated if it were found practicable to continue the use of the old unit in conjunction with other units of like or larger capacity.

The element of accrual with respect to inadequacy is usually a matter of conjecture, but it can be better determined than with respect to obsolescence, the trend of business being the governing factor.

Regulatory bodies and taxing authorities provide that inadequacy is to be considered in conjunction with wear and tear and obsolescence in arriving at depreciation rates.

Communications should be addressed to any one of the undersigned.

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Current Literature

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The JOURNAL of ACCOUNTANCY

Official Organ of the AMERICAN INSTITUTE of ACCOUNTANTS

Vol. 34

OCTOBER, 1922

No. 4

American Institute of Accountants

REPORT OF THE PRESIDENT *

Another year in the life of the Institute has gone from the present forever and has been absorbed into that limitless past in which all things which make for the good or for the ill of the future have their birth and their sole origin. This is the process of history. We who are a part of the present are charged with the responsibility for shaping the future. The annual meeting of the Institute which marks the close of one fiscal year and the beginning of another is the natural point of rest when a balance-sheet can be prepared and the historical record of the profit-and-loss account can be interrogated so that those charged with the affairs of the future may work in the light of the lessons learned from the past. It is the time for taking stock, for closing the books of the past and for opening the accounts of the future.

It has been the custom for your president to make his report a review of the outstanding features of planning and accomplishment of the year which has been brought to a close by the annual meeting and to invite attention to a consideration of the problems of the immediate future. I ask your indulgence if I depart from this established custom and not only deal with the items which comprise the historical record of a year's activities but also comment upon some of the items that comprise the assets and the liabilities in our metaphorical balance-sheet which presents the present moral and intellectual position of the Institute—the result of the whole of the past rather than the result of only that brief interval of time which we call a year. With your permission therefore this report will be both historic and homiletic.

Under the historic section let me invite your attention to only a few of the outstanding events of the year and ask you to refer

* Presented at the annual meeting of the American Institute of Accountants, Chicago, Illinois, September 19, 1922.

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to the reports of the council and of the executive committee for a more complete review of the administration of the affairs of the Institute during the past year.

During the year your president or your secretary or both visited and conferred with groups of members in nearly every section of the country. Under instructions of the executive committee several topics were discussed and an expression of opinion was obtained at meetings held in about thirty-five cities.

One of the subjects discussed at these meetings was the question of modifying the existing requirements for admission to the Institute. As a result of these conferences and in accordance with suggestions by the council your board of examiners modified its rules so as to carry out what seemed to be a consensus of opinion in respect to the admission of possessors of C. P. A. certificates of an approved standard without an additional examination by the examining board of the Institute. To accomplish this result by means of a rule of the board seems to be a better and a more desirable method of procedure than to amend the organic law by any change in the constitution and by-laws. Such a change is both unnecessary and unwise.

Another subject discussed at these meetings was that of corporate publicity and propaganda to be undertaken by the Institute. The committee on professional advancement has now formulated plans and has addressed a circular letter to each member. Its programme can be inaugurated as soon as the requisite financial support is assured. The oral and moral support given to this programme seemed to be almost unanimous and very enthusiastic. Approval and enthusiasm, however, will not suffice to carry out this ambitious and expensive undertaking, and a minimum of \$100,000.00 a year for five years must be reasonably assured before your committee can proceed with its plans.

Regional meetings of the Institute now seem to have passed the experimental stage and have become an established feature of Institute activity in a number of sections of the country. During the past year regional meetings were held in Des Moines, Pittsburgh, Hartford, Indianapolis, Cleveland and Boston. It was my privilege and pleasure to attend and to address several of these meetings. Instructive papers were presented and discussed, and delightful social and professional relations were established. The opportunities which regional meetings afford

for bringing about closer association and coöperation between accountants are many, and I would urge other sections of the country to consider the organization of regions so as to avail themselves of the benefits and the pleasures which these meetings have been to those regions which have pioneered in this movement establishing a closer contact and a better spirit of coöperation among all practising accountants—non-members as well as members of the Institute.

The so-called Capper bill, which follows the model C. P. A. bill formulated by the Institute, has passed the senate and has been recommended for passage by the house committee and is now upon the house calendar. Everyone is familiar with the pressing legislative programme which has engaged the attention of congress during the past year and has prevented earlier action upon this bill. It is hoped that the bill will be reached during this session of congress. When it shall have been passed, every political division of continental United States except Alaska will have enacted C. P. A. legislation. All of this legislation does not measure up to Institute standards and some laws are not always efficiently administered, but when it is remembered how long it has taken the older professions to establish proper standards (if indeed such standards have yet been established) it is altogether encouraging to note the progress which accountancy has made in so short a time.

The hearings on the Capper bill and the opposition it received from representatives of the now harmless District of Columbia private corporation organized to deal in C. P. A. certificates has done more to educate Capitol Hill upon the subject of accountancy, its aims and aspirations than many years of affirmative propaganda could have done.

The last annual meeting adopted a resolution which empowered the council to formulate a rule of professional conduct dealing with the question of proper publicity for a professional accountant. Your president promised that no hasty nor ill-considered action would be taken. Now that the committee on professional advancement has formulated a plan for corporate publicity which only awaits your financial response to be put into immediate operation, I believe that the time has arrived for drastic action in respect to the scandalous practices which have threatened to bring disrepute upon the Institute and our profession as a whole.

The National Association of Certified Public Accountants was formed shortly prior to the last annual meeting. This organization caused considerable distress to a large number of our members and others. Its charter seemed to grant the right to bestow the C. P. A. designation upon all those who purchased its certificates. This attempt to commercialize the C. P. A. certificate threatened to destroy the value which the certificate had attained in many states of the union. The words "certified public accountant" seemed to be in great jeopardy of becoming entirely meaningless.

Your executive committee, however, promptly planned to combat the threatened evil and in less than a year the legal steps initiated by the Institute have resulted in a permanent injunction which has forever allayed the groundless panic caused by this unsubstantial spectre of fear conjured up by a combination of those who do not love the Institute and those timid souls who are frightened every time the wind blows above a zephyr.

With these brief references to some of the activities which have engaged your president during the past year, I will leave the historic and come to the didactic portion of the last report it is my privilege to make to you as president of the Institute. Following the unwritten law of our country, our constitution wisely provides that the president shall not be eligible to re-election for more than a second term. This address is therefore, not only the annual report of the president, but it is also his valedictory. He can only have the welfare of the Institute in mind and can not be actuated by sentiments of personal ambition or pride of opinion in taking advantage of the occasion and for the moment assuming the role of preacher and prophet.

We are sometimes prone to take a narrow and myopic view of our immediate surroundings, when we should leave the valley and climb a hill whence a broader vision may be obtained. My father used to tell me a story about an old woman who had lived her whole life in a valley entirely surrounded by hills. She had never seen the landscape which unfolded itself beyond the hills that had circumscribed her outlook. There came a time when two of her grandchildren, whom she had never seen, visited the place of birth of their ancestors. Among the points of interest it was their desire to see was the ruin of a mediæval castle on a hill beyond those which surrounded the valley in which their grandmother dwelt. An excursion was arranged and a vehicle

was engaged to take them to the historic place and they persuaded the old lady to accompany them on what to her was an adventurous and hazardous journey to strange and foreign parts. As the slow moving and deliberate farm-horses brought the wagon to the brow of the hill and what seemed to her an unlimited prospect was unfolded to her vision, her eyes filled with tears and with emotion she exclaimed, "Children, how big the world is!"

Will you permit me to invite you to abandon the narrow and circumscribed viewpoint which to our minds so often unduly magnifies the little and unimportant things of life into things of great size and importance? Let us together climb a hill whence we may obtain a broader outlook and have a larger vision of the purpose and the functions of this Institute to which we belong and which should be to each of us, not only our alma mater, but, may I say, our professional church in which we worship and which we desire to employ as an instrumentality for increasing the dignity and the usefulness of our profession.

"Rome was not built in a day," says the hackneyed proverb. The Institute was not built when its constitution was adopted, nor do I believe that it would be entirely destroyed by adoption of ill-considered amendments proposed by those for whom I pray a larger vision and a nobler attitude of mind. The Institute is a living and a growing organism. It has not reached perfection nor can it ever hope to do so. Should the time ever come when it can be said of the Institute, "It is finished," the time will also have come when its usefulness shall have passed and the breath of life shall have gone out of it. It may seem to live for a time but it will only be a living death.

The psychology of the present is the psychology of the aftermath of war. It is a period of unrest and neurosis in all departments of human activity. This spirit of unrest pervades the social and the political atmosphere. Is it surprising that it should also infect the Institute and its membership in their personal and professional relations? This is a time when men need sane and unselfish leadership that the things which have been so slowly and laboriously achieved shall not be lost and the light of the present be succeeded by the darkness which enveloped a former uplift of man in his struggle from chaos into consciousness. We, each of us, have a duty to participate in movements for the general well-being, but we have a

more immediate duty to concern ourselves with the welfare and the improvement of our own profession.

When the children of Israel returned from captivity to re-establish their city of Jerusalem and to rebuild its walls, the injunction was given them that each man should rebuild the wall in front of his own house. It is the more immediate concern of each of us to help solve the problems of our own profession than it is to concern ourselves with the general problems of our common civilization. If each of us gives the best that is in him for his own profession or vocation, the aggregate result must be the best for mankind in general.

In order to obtain a proper perspective of our problem let me again refer to our metaphorical balance-sheet so that we may see what assets have been acquired, what liabilities have been discharged or are in process of liquidation and for what liabilities we must yet provide. This will give us a better understanding of the efficiency and usefulness of our present plan of organization. It will enable us better to decide whether or not it should be reorganized and the present structure abandoned for one which some would have us believe to be more habitable and better adapted to our needs.

In the process of the evolution of the organized profession, the centralized and responsible authority of the Institute succeeded the diffused and irresponsible authority of the old American Association. This evolutionary process was analogous to the one by which our present national union succeeded the federation of states which ended with the adoption of the constitution of 1789.

The organization of the American Institute of Accountants was an attempt to supplement political legislation, which had not always been for the best good of the profession, by the creation of a national body which should control and regulate the practice of the profession from within the profession itself. This can be done far better by precept and example than by passing statutes. Effectually to accomplish this result it was necessary to give the Institute a thoroughly democratic form of organization—one which would prevent the government of the Institute from becoming irresponsible to the majority opinion formed after full discussion and careful deliberation. But it was also necessary that it should have continuity and that it should avoid the proven dangers which are inherent in applying town-meeting methods

of government to any organization other than one of such small geographical dimensions that every member personally knows every other member and his problems.

The present plan of organization has accomplished the desired result; and suggestion to change it does not make for more democracy but for irresponsibility and leads toward anarchy.

Let me urge upon you to take a national and not a local or provincial view of your profession. It is my firm belief that but for the Institute the C. P. A. certificate for which we have worked so hard would today be nearly meaningless in most of the states of the union. The creation of the Institute with the opportunity thus given to the Institute's board of examiners to evolve a plan of coöperation with state boards of accountancy has not only gone far toward the standardization of C. P. A. certificates but it has been the means of preserving in many states what was so laboriously gained only to be threatened by a condition which was worse than to have had no C. P. A. law whatever.

The accomplishments of the Institute have been many. I would like to enlarge upon some of them but, in view of the demands which this meeting will make upon the time at our disposal, it will be impossible to do so. To those who have carefully followed the Institute's course it will be unnecessary. A mere mention of the library and the helpfulness of its bureau of information; of the dignified and scholarly character of its increasing number of publications; of the standing and reputation it has achieved among government officers and among eminent bankers and business functionaries; of the ever-widening force and power it is becoming in establishing standards and affecting the professional conduct of practitioners; of the still greater opportunities yet before us to make our beloved Institute an instrument of influence and power in upbuilding and increasing the usefulness and the dignity of our calling—a mere mention of these should suffice to convince you that if the Institute stands by its present policies it will accomplish far more than if it is blown about by every false wind of doctrine.

I have the greater part of my life behind me and I do not believe that the observations which I have made and the experiences which I have had of men and of movements have been altogether without profit in enabling me to have some vision of the things which make for the greater good of man. I would feel myself to have been false to a sacred trust did I

not as my last official act call upon you not to heed the preachers of discontent and did I not exhort you to stand firm and not be stampeded by the spirit of unrest which is sweeping over the world and is of the kind that has always followed in the wake of a great calamity.

CARL H. NAU.

Reserves*

BY H. A. FINNEY

The reserve account is a jack-of-all-trades and badly over-worked. It has to do duty in too many capacities and to serve in too many liveries. It is, like Pooh Bah in *The Mikado*, Lord High Everything. This fact is well stated by Mr. Montgomery, as follows:

“The status of the reserve account is unsatisfactory from the point of view of the professional auditor, chiefly because the term ‘reserve’ is indiscriminately applied to items which are essentially different.”†

This essential difference in the nature of various reserves may be shown by three pairs of contrasted illustrations:

The first pair: when depreciation has reduced the value of a fixed asset, we set up a reserve for depreciation. And when market conditions have increased the realizable value of the same fixed asset, we may set up another reserve for the unrealized profit. Thus one reserve measures the estimated increase in the value of an asset.

The second pair: a company has capital invested in a mine or other wasting asset. At the close of each period the reserve for depletion is credited with the estimated value of the deposit extracted during the period. This reserve measures a decrease in asset values which has actually taken place in the past and a decrease which is chargeable to the operations of the past. But suppose that a corporation, after providing for all known losses, sets up a reserve for contingencies. This reserve represents a vague and problematical loss; one which has not yet been suffered, which may in fact never be suffered and should certainly not be a charge against the operations of the past.

The third pair: taxes are accrued at the end of the period, and a reserve for taxes is set up. This reserve represents a liability, and the offsetting debit records an expense. Contrast this with a reserve for sinking fund, which is not a liability but a part of the surplus. The entry setting up this reserve does not record an expense; it merely records the fact that, because of a

* A paper read at the annual meeting of the American Institute of Accountants, Chicago, Illinois, September 19, 1922.

† R. H. Montgomery, *Auditing Theory and Practice*, 1922, vol. I, page 267.

contract with the bondholders, a portion of the surplus is temporarily not available for dividends.

From these illustrations it appears that some reserves are set up because actual expenses or losses have occurred in the past; others are set up because contingent losses may possibly occur in the future; others indicate that profits could be realized by the sale of fixed assets; while others represent neither a profit nor a loss, but a temporary earmarking of a portion of the surplus.

Some reserves are a part of the surplus; some represent real liabilities; some represent contingent liabilities; some are related to assets, and these asset reserves may show that the property has already decreased in value, or that it may possibly decrease in value at some time in the future, or that it has actually increased in value. Some reserves are set up by charges to profit and loss, some by charges to surplus, and some by charges to asset accounts.

This multiplicity of reserves, meaning so many things, set up in so many ways, and appearing in so many places in the balance-sheet, is bound to result in confusion. This confusion ought to be avoided. Any term appearing in the balance-sheet should, if possible, be self-explanatory, and the term "reserve" can scarcely be self-explanatory when it may mean a deduction, already suffered, in the value of an asset, or a possible future deduction in the value of an asset, or an unrealized profit, or a real liability, or a contingent liability, or a mere segregation of a portion of the surplus.

If the term "reserve" is not self-explanatory, and if the danger of confusion is real, it would seem desirable to limit the use of the term to a few accounts, all of a similar nature; and this would in turn require the development of a larger, richer and more precise vocabulary, supplying terms by which to designate accounts which are now called reserves, but to which that title would no longer be applied.

Any alteration or attempted standardization of accounting terminology can be expected to have cogency only to the extent that it is sanctioned by the American Institute of Accountants. It is proper, also, to expect that the institute, in considering suggestions of this nature, should act through its committee on accounting terminology. As this committee has asked for suggestions and co-operation from the membership of the institute,

the proposals as to terminology offered in this paper may be considered an open letter addressed to the committee.

CLASSIFICATION OF RESERVES.

Before discussing various reserves and offering suggestions as to terminology, I wish to submit a classification of the accounts to which the term "reserve" has been applied. Various classifications have appeared in texts. One writer classifies them as real and nominal; another as operating and non-operating; another as necessary and voluntary; another as valuation reserves and proprietorship reserves; another as reserves out of income and reserves out of surplus. It seems to me that there should be three main groups, with subdivisions, as follows:

- I. Profit-and-loss reserves, set up by debits to profit and loss, because some expense, properly chargeable to current operations, has resulted in

- (a) A decrease in the value of an asset; or
- (b) The creation of a liability.

(For the sake of emphasis I may say that later in this paper I shall suggest that the term "reserve" be restricted to accounts of this class, and that other terms be applied to accounts belonging in other classes.)

- II. Surplus reserves, representing

- (a) Conservative provisions for possible future losses, not already incurred; and
- (b) Appropriations of surplus, ear-marked as unavailable for dividends because of
 - (1) Contracts with bondholders, other creditors, or preferred stockholders, in relation to sinking funds.
 - (2) Action by stockholders or directors intended to limit the payment of dividends for various financial reasons.

- III. Reserves for unrealized profits.

This three-fold classification recognizes that some reserves are set up because expenses and losses have decreased the net profits; reserves of the second class represent, not deductions from net profit or total surplus, but merely a division of the surplus into two parts: surplus which is available for dividends and surplus

which, for the time being at least, is not available for dividends; while reserves of the third class represent unrealized profits which, if put on the books at all, should be kept out of surplus.

DISTINCTION BETWEEN PROFIT-AND-LOSS RESERVES AND SURPLUS RESERVES.

Before discussing profit-and-loss reserves I want to make as clear a distinction as I can between profit-and-loss reserves and surplus reserves. Profit-and-loss reserves are set up by charges to nominal accounts or some section of the profit-and-loss account, and are necessitated by the fact that some expense has reduced the net profit for the period. Mr. Dickinson calls them "necessary" reserves. The term "necessary," as applied to these reserves, does not seem sufficiently restrictive, because some appropriations of surplus which do not in any sense represent expenses or losses are necessary. For instance, a reserve for sinking fund is necessary if the contract with the bondholders requires it. However, Mr. Dickinson's meaning is clear: the reserve is necessary in order to determine the true net profit.

To be a true profit-and-loss reserve, the account must represent a provision for an expense or a loss which has already been incurred and is properly chargeable to current income. It is not necessary that its amount be definitely ascertainable, but there must be a certainty, or at least a high degree of probability, that the loss has actually been incurred as a result of past operations.

To show the difference between a profit-and-loss reserve and a surplus reserve, let us assume that a company owns valuable machinery which it uses in manufacturing a peculiar type of product and it could not use in the manufacture of any other product. A reserve for depreciation will be necessary because of the certainty that depreciation is continually taking place. Since depreciation is a proper charge against current operations, the reserve for depreciation is a profit-and-loss reserve.

But there is also a possibility that the product manufactured by this machine may be superseded by some other article, or that a new machine may be invented which will render the machine now owned obsolete. It may therefore be desirable to set up a reserve for supersession or obsolescence. This will not be a profit-and-loss reserve because the loss has not yet occurred, there is no certainty that it will ever occur, and even if it does

occur it will not be a result of the company's operations. If a provision is made for this possible loss—and it would be conservative to make such a provision—it should be made out of surplus, and the account representing the provision should be recognized as a part of the surplus and so be shown on the balance-sheet.

Having made this distinction between profit-and-loss reserves and surplus reserves, I wish to make two suggestions as to terminology before proceeding to a further discussion of profit-and-loss reserves. These suggestions are:

First, that the term “reserve” be applied only to accounts set up because of operating expenses or losses, and that accounts set up out of surplus to provide for contingent future losses shall be given some title other than “reserve”.

Second, that if the amount of the operating expense or loss can be definitely computed it should be booked in some manner other than by crediting a reserve.

If these suggestions should be adopted, the reader of a balance-sheet could be sure that all reserve accounts appearing therein represent provisions for operating expenses actually incurred and not merely contingent, but impossible of exact computation at the present time. And if self-explanatory titles can be found for the other accounts now appearing as reserves, much of the cause for confusion will be avoided.

PROFIT-AND-LOSS RESERVES.

Profit-and-loss reserves, set up because of current operating expenses, may be divided into two sub-classes: reserves representing deductions from the value of assets and reserves representing liabilities.

Let us consider the first sub-class: reserves representing deductions from the value of assets. I have suggested that the term “reserve” be used only in case the amount of the expense or loss, and consequently the amount of the decrease in asset value, can not be definitely computed. This is the case with the reserve for depreciation, the reserve for depletion and the reserve for bad debts. These titles should be retained. The layman is already fairly familiar with them; the deduction of the reserve from the related asset account makes the nature of the reserve self-evident; and the layman can be relied upon to realize that

an exact computation of the deduction is impossible and that the reserve is only an estimate.

But reserves have often been set up to record decreases in asset values which are exactly measurable. As an illustration, let us assume that a company leases property for a period of ten years and proceeds to make leasehold improvements which will revert to the owner of the real estate at the expiration of the lease. The asset of leasehold improvements decreases in value by exactly one-tenth of the cost. Some accountants might set up a reserve for leasehold improvements; but since the amount of the annual reduction in value is definitely known, it would seem preferable to write down the asset.

Turning now to the second sub-class of profit-and-loss reserves, those representing liabilities for expenses already incurred, we find that the amount of the liability may be only an estimate or it may be definitely known. If the amount of the liability is only an estimate, as in the case of accrued taxes, there can be no objection to the use of the reserve title, although I am inclined to believe that greater clearness would be obtained by using a self-defining title such as "estimated liability for taxes".

But when the amount of the liability can be accurately computed, it seems preferable to record the liability in some account other than a reserve. Mr. Kester has stated this point clearly and emphatically, as follows:

"Why unpaid expenses of any kind should be called reserves for expenses when the amount of them is definitely known has never been satisfactorily explained; yet the practice is sometimes met. There is some excuse in the case of expense items the amount of which cannot be definitely determined either from the nature of the item itself or other condition over which the concern has no control. Thus, 'reserve for wages' is usually a misnomer, the title 'wages accrued' showing the item correctly; but 'reserve for taxes', while just as true a liability as the other item, may be justified on the ground that the latter is only an estimate subject to correction when the exact amount is known, whereas the former is already definitely known."*

Before proceeding to a consideration of surplus reserves and reserves for unrealized profit, I should like to summarize what

* Roy B. Kester, *Accounting Theory and Practice*, vol. 2, page 415.

has been said about profit-and-loss reserves. I have suggested that the term "reserve" be used only in case the account is set up because an actual operating expense or loss of unascertainable amount is known to have occurred. If the loss is contingent and problematical it may be provided for out of surplus, but the provision should not be called a reserve. If the loss is certain in amount it should be recorded otherwise than by a reserve.

Thus, estimated deductions from assets on account of depreciation, depletion and bad debts and estimated liabilities for expenses such as taxes would be recorded in reserves. Exactly measurable deductions from assets would be recorded by writing down the asset accounts; exactly measurable liabilities for expenses would be recorded in liability accounts. Contingent deductions from assets and contingent liabilities on account of expenses or losses which may or may not occur in the future would be provided for as conservative appropriations of surplus.

SURPLUS RESERVES.

This brings us to the second main class of reserves, namely surplus reserves. These may be divided into two sub-classes, as follows:

- (a) Conservative provisions for possible or contingent future losses; and
- (b) Appropriations of surplus for financial purposes, such as the sinking-fund reserve or the reserve for extension of plant.

Both these classes of surplus reserves have this distinctive and very important feature in common: they are a part of the surplus and should be shown as such on the balance-sheet.

Dealing with the first sub-class, conservative provisions for contingent losses, we find that it may be further subdivided, for if the contingency becomes a reality the loss may result in decreasing the value of an asset or in creating a liability. To illustrate a contingent reserve for loss on an asset, let us assume that the books are closed using the market value of the inventory at December 31st, which is lower than cost; but there is danger that the market may still further decline, causing additional loss. Consequently a reserve is set up by charging surplus and crediting a reserve for market fluctuations in inventory. This reserve provides for a contingent loss on an asset.

To illustrate a contingent loss which may result in a liability, let us assume that this concern employs men to work in its factory, and that there is a possibility that workmen may be injured and liabilities for damages incurred thereby. A reserve may be set up to provide for this contingent loss and contingent liability.

Concerning surplus reserves for contingent losses, I wish to express an opinion on four points:

First, when a reserve is set up to provide for a loss, the profit-and-loss account should be charged only in case the loss has already been incurred. If the loss is contingent, the charge should be made against surplus. Thus, in closing the books at the end of 1921, a reserve for possible losses in inventories due to any market declines which may take place in 1922 should not be charged against current profits of 1921, because the loss has not yet occurred, it may never occur, and if it does occur it will be a loss of 1922. If a reserve for accidents is being set up at the end of 1921 because future accidents may result in liabilities, this reserve should be a charge against surplus.

I am willing to go so far as to say that a reserve for fire loss, in case of self-insurance, should be created out of surplus and not out of current income. It may sound radical to say that profit and loss should not be charged when the reserve for insurance is credited, and I am not sure that I would have the temerity to make the assertion if I were not supported by the good authority of Mr. Dickinson, who places the "provision for insurance against future possible losses from fire and other insurable risks" among the "mere allocations of surplus."* Moreover, it seems to be a position which can be logically defended. Profit and loss ought not to be charged unless a loss has already occurred. The amount may not be ascertainable, but it must have occurred before profit and loss can properly be charged, and it must have been the result of past operations. Now a loss can not occur without reducing the value of an asset or creating a liability, and conversely if the assets have not been reduced in value and if a liability has not been created there can have been no loss. This seems to be the case when a reserve for fire loss is set up. Until the fire occurs, the assets are still in existence; the net worth has not diminished; there has been no loss which is properly chargeable against operations (even assuming that

* A. Lowes Dickinson, *Accounting Practice and Procedure*, pages 149 and 150.

a fire loss is an operating expense), and the reserve is a part of the surplus. It may be argued that where available experience figures are adequate to furnish a trustworthy estimate of the future loss, a periodical charge should be made to operations to equalize this loss in order to maintain uniformity. The answer to that argument seems to be that an appearance of uniformity is not desirable when there is no real uniformity.

The second thing I wish to say in regard to surplus reserves for future contingencies is that if a loss does occur it should be charged against the reserve only in case it is an extraneous loss, and that if it is an operating loss it should be charged to profit and loss regardless of the existence of the reserve.

To illustrate, assume that a reserve is set up at the end of 1921 for possible losses on inventories from market declines which may take place in 1922. If the loss occurs it should be dealt with as other operating expenses are dealt with and should be reflected in the profit-and-loss account for 1922. Unless the reserve is needed for other possible losses, it should be returned intact to surplus. But if a reserve has been set up for fire losses, the reserve may properly be charged in the event of a fire. A fire loss is extraneous to operations; it is a proper charge to surplus, and the reserve for fire loss is merely a portion of the surplus set apart and retained for the purpose of absorbing such losses.

The third thing I wish to say is that, since such reserves are in reality surplus, they should be called surplus, although the title of the account should indicate that it represents surplus reserved or withheld from dividends in order to avoid a deficit in the event of some specified loss. I suggest such titles as "surplus reserved for contingent fire loss," "surplus reserved for contingent accident loss" and "surplus reserved for contingent inventory loss."

The fourth thing is that these accounts should appear in the balance-sheet as a part of the surplus. Thus in the balance-sheet we might have:

Surplus:

Reserved for contingent fire loss	\$25,000.00
Reserved for contingent inventory loss .	10,000.00
Total surplus not available for dividends	<u>35,000.00</u>
Free and available for dividends	60,000.00
Total surplus	<u>\$95,000.00</u>

We now come to the second sub-class of surplus reserves: those which are appropriations of surplus, not intended as provisions for contingent losses but designated as not available for dividends because of a contract with bondholders or stockholders or because of some financial policy of the management. In this class we find the reserve for sinking fund, the reserve for working capital and the reserve for extension of plant.

In discussing this class of reserves, I have six things to say.

First, it would be advisable to discontinue the use of the term "reserve" and use in its place the term appropriated surplus—thus, "surplus appropriated for sinking fund," "surplus appropriated for working capital" and "surplus appropriated for extension of plant."

Second, these accounts should be shown on the balance-sheet as part of the surplus, thus:

Surplus:

Reserved for contingent fire loss	\$25,000.00
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Appropriated for sinking fund	10,000.00
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Total surplus not available for dividends	35,000.00
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Free and available for dividends	60,000.00
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Total surplus	\$95,000.00
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Third, in the case of so-called sinking-fund reserves, the appropriated surplus should be the amount which ought to be in the fund if the corporation were exactly meeting its obligations in the matter of contributions and if interest were being accumulated at the theoretical rate used in determining the amount of the annual contributions. Thus the fund account will show what is actually in the fund, while the reserve will show what ought to be in the fund.

Fourth, these accounts should not be set up by charges to profit-and-loss, and their existence should in no way affect the profit-and-loss account. There was a time when the credit to the sinking-fund reserve was offset by a debit to profit-and-loss. This is no longer done, but many accountants still charge sinking-fund expenses against the reserve and credit sinking-fund income to the reserve instead of passing them both through the revenue account. Thus the existence of the reserve does improperly affect the profit-and-loss account. It is wrong to charge profit-and-loss

and credit the reserve when the cash contributions are made to the fund, because current income is thereby understated; and it seems equally incorrect to understate current income by crediting sinking-fund earnings direct to the reserve instead of passing them through the revenue account.

Fifth, these reserves may be required by contract or they may be optional. The trust indenture of a bond issue may specifically require the segregation of surplus as well as the creation of a fund; or the requirement may be implied by the provision that the sinking fund shall be provided "out of profits." The same may be said if the sinking fund is to be used for the retirement of preferred stock.

It is often contended that an appropriation of surplus for a sinking fund for bonds or for preferred stock is expedient even though it is not obligatory. The argument in support of this contention runs somewhat as follows: The bonds or preferred stocks were issued because additional fixed assets were required and the funds for their construction could not be spared from the working capital. And since it is impossible to make sinking-fund contributions and also to pay dividends to the full amount of the profits without an eventual impairment of the working capital it is advisable to set up a sinking-fund reserve or appropriation of surplus to prevent the payment of dividends to the full extent of the profits.

While it is true that the payment of annual dividends equal to the annual profits would in many cases result in an impairment of the working capital, it does not seem to follow that the creation of an appropriated-surplus account is essential. It is not essential if the directors can be relied upon to give due consideration to financial requirements when determining the amount of dividends to be paid. Corporate directors as a class can scarcely be charged with having sacrificed the financial stability of the corporations under their control by unwise dividend policies, and it is doubtful whether they need the self-imposed restriction of an appropriated-surplus account. It is sometimes said that the reserve is desirable to prevent stockholders from clamoring for dividends equal to the balance of the surplus account. If this reasoning is sound, the logical conclusion would be that the directors should transfer from ordinary surplus to permanent surplus all of the balance of the former account except the amount which can safely be paid in dividends. This

surely is not necessary as the very purpose of the surplus account is to carry the profits not to be distributed as dividends.

Sixth, if the sinking-fund reserve or appropriated-surplus account is required by contract, it should not be returned to surplus until the last bondholder or preferred stockholder has been paid off through the sinking fund. This question rarely arises in regard to a sinking fund for bonds, but it does arise in regard to a so-called sinking fund for preferred stock, because of the difference in the methods of operating the two types of funds. When a sinking fund is created for bonds, the bonds purchased for the fund are held alive: thus the fund and the reserve steadily increase in amount until the maturity of the issue. But the sinking fund for preferred stock is increased by contributions and forthwith decreased by the purchase and cancellation of stock. The fund rises and falls; it does not steadily accumulate. Then why accumulate the appropriated surplus? Because the appropriation of surplus is made in order to safeguard the working capital, to avoid the jeopardizing of future earnings and to maintain the company in an income-producing condition that will enable it to meet future sinking-fund requirements for the retirement of the remaining stock. The last preferred stockholder to be paid off through the sinking fund has the right to this protection.

UNREALIZED-PROFIT RESERVES

Finally, we come to the third main class of reserves: accounts which are set up because fixed assets have increased in market value and because the write-up ought not to be carried into surplus. For these accounts I suggest the title "unrealized increment." For instance, "unrealized increment in land value" or "unrealized increment in plant value." Thus we would get away from one more use of the term "reserve," and the term "unrealized profit" is self-contradictory. If the increase in value is unrealized it can not be a profit.

Some might say, Credit capital surplus. In my opinion the word "surplus" should not appear in the title of an account unless that account contains real surplus, either appropriated for some reason or free for dividends. Let the surplus account contain operating profits, and let the capital-surplus account contain extraneous additions to surplus which, though not arising from operations, are nevertheless realized and legally available for dividends.

Others may say, Keep the increase in market value off the books. This has often been said, but it seems to me that it is not necessary. It is only necessary to make sure that the corporation does not credit the increase to surplus and incur the risks of using this credit for dividends. If the credit is passed to an unrealized increment account, clearly understood to be unavailable for dividends, and so shown on the balance-sheet, I see no objection to allowing the corporation to show the present value of its fixed property.

SUMMARY.

To summarize, so far as terminology is concerned, I suggest that the term "reserve" be used only when some expense, properly chargeable to profit-and-loss, has decreased the value of an asset by an indeterminable amount or created a liability which can not be accurately computed. Thus the appearance of a reserve on the balance-sheet would always mean that profit-and-loss had been charged for an estimated operating expense.

If the amount of the decrease in the value of the asset is exactly measurable, credit the asset account; if the amount of the liability is exactly measurable, credit a liability account.

If the loss has not yet occurred, but is contingent upon some future and uncertain event, any provision for the loss should be made out of surplus; the account should be called "surplus reserved" for this or that contingency; and it should appear on the balance-sheet as a part of the net worth.

Mere appropriations of surplus, for sinking funds, working capital, extensions, equalization of dividends, etc., should be called "surplus appropriated" for such and such a purpose; and so-called unrealized profits should be credited to unrealized-increment accounts.

Treatment of Foreign Exchange in Branch-office Accounting*

BY CECIL S. ASHDOWN

In recent years, accountants have been confronted with many old problems in new forms, connected with business abroad. On referring to text-books and periodicals devoted to accounting which have appeared from time to time it will be found that, generally speaking, these touch lightly on our present-day complexities. All appreciate the difficulties which an accountant has to face in preparing a financial statement which involves profit or loss resulting from foreign trading and in the proper presentation and preparation of statements of profit and loss for taxation purposes.

Prior to the commencement of the world war, our interests in foreign business as a nation were relatively minor in character and largely confined to the disposal of our surplus foodstuffs and raw materials, and limited to a few pioneers in the foreign field who sought new outlets for specialities. Interest in foreign trade and the development of our trade relations is now, however, widely distributed throughout the country, and the accountant must be prepared to advise his clients as to the preparation of the accounts of their foreign business. Prior to the war, in this country, there were few accountants and, probably, fewer business men who could readily quote the exchange rates in the various countries; in fact, it was hard to find quotations in many of our leading papers. Today, foreign exchange rates are featured, and all of us are more or less conversant with the current rates prevalent in the principal foreign countries. I fully recognize that it is within the experience of many that the currencies of some of our neighbors to the south were depreciated to an extraordinary degree; but the volume of business conducted with these countries was small, consequently of little interest to the great majority of accountants. Today, however, the subject before us is one well worthy of careful consideration by all accountants whether they are concerned with foreign undertakings or not.

*A paper presented at the annual meeting of the American Institute of Accountants, Chicago, Illinois, September 20, 1922.

I shall not attempt to discuss here the causes underlying exchange fluctuations and the theories of economics involved, but I wish to bring to attention some of the difficulties which arise in attempting to translate the effect of these fluctuations in the accounts of a business which, today, is trading abroad. In the space at my disposal, it is impossible to deal with more than one phase of the many different kinds of foreign commercial branch activities, and I shall, therefore, confine my remarks to a consideration of the accounts of a manufacturer in the United States who markets his product at home and also has branch houses abroad.

BRANCH RECORDS

In the case of a foreign branch established in a country where the currency was on a gold basis, up to comparatively recent times, it was considered sufficient for all practical purposes to treat the rates of exchange as stable or fixed. A par rate or a figure near that point, which facilitated conversion of transactions from one currency to another, was adopted for the purpose of converting monthly transactions; any entry necessary to bring to current rates, being of relatively minor significance, was treated as a profit or loss debit or credit, usually on the home office books.

Since the termination of the world war, exchange rates have been fluctuating violently, particularly in those countries directly concerned in the war, so that at the present time, except in a few instances, all sense of stability in exchange rates has disappeared. As an illustration, the Italian lire which was worth at par 19.30 cents has touched a low point of 3.50 cents and is today about 4.45 cents or a depreciation of 76% from par, this in turn being a reaction from a recent high point of 5.30 cents. Obviously under these conditions the conversion of transactions at a fixed rate is misleading and entirely unsatisfactory in making a presentation of the results of a foreign-branch business.

From what I can learn some concerns today are still adhering to the normal or pre-war basis of conversion and in some instances presenting their consolidated profit-and-loss account on these lines. In other cases a new fixed rate has been established. Clearly when there is a substantial percentage of reduction from par, which is fluctuating from

month to month, the sales and expenses when converted at these rates are both overstated and mean little, with the result that the management of the business concerned is apt to believe the volume of the foreign business and amount of expense is much larger than is really the case, and thus the management gets a distorted viewpoint of the foreign business, unless it confines attention to the accounts in local currency.

It is essential that the accountant keep three distinct points clearly in mind:

FIRST—The home-office records must properly set forth the investment in the foreign branch, and only such profit or loss on exchange as affects this investment should be taken up on the home-office books.

SECOND—The branch-office records must correctly set forth its individual financial position from a local point of view and only the exchange adjustments which affect the branch profit-or-loss account must be taken up on the branch books.

THIRD—Both the home-office and branch balance-sheets and profit-and-loss accounts must be so consolidated, that the combined financial statements reflect the true position from a consolidated standpoint.

The accounts to be opened and exchange entries to be made in the books of the local branch or local incorporated subsidiary company will depend necessarily upon the terms of the contract between the branch and the parent company, expressed or implied, which governs the conditions of purchase of goods from the home-office.

The branch-office must at all times show its true liability to the home-office for purchases, which should be considered separately from advances by home-office to finance the acquisition of local fixed assets. These advances are frequently represented by capital stock of the local company or some form of branch indebtedness other than current account. Local working capital often is provided by home-office through extension of credit for goods shipped to the branch for local sale or provided by the accumulation of local profits.

In practice it will be found usually that where the branch has been operating for a number of years its liability to the

home-office on current account represents an accumulation of credits for purchases less remittances on account of goods purchased and local profits made. In these circumstances the true liability of the branch to home office cannot be stated without an adjustment of the profits or losses of the branch of previous years. Where remittances have been made in local currency, and there is no definite contract between home-office and the branch, the probability will be that the exchange loss debits in the home-office profit-and-loss account have been overstated; on the other hand where the branch has been making profits and has remitted more than its dollar liability to the home-office for goods purchased the charges to profit-and-loss for loss on exchange will have been overstated in the local books.

It is a common practice to pay the local branch manager a share of the local profits; for this reason, it is necessary that the local profits be stated correctly. Further, today, as many countries are basing taxation on profits, it is essential that the local profits be properly stated, so that proper returns may be made to the local tax authorities. We have no monopoly on tax questions in this country, each and every country has its own, and an accountant who has in his charge the accounts of a dozen branches, in as many different foreign countries, has his hands full of these problems, which he cannot expect to cope with satisfactorily without assistance from local counsel and local public accountants.

For the purpose of continuing the illustration we shall assume the case of a manufacturer in the United States who has formed a branch in a foreign country, which is either conducted as a branch in the name of the parent company or incorporated locally as a company with limited liability, with or without local participation in the capital stock and with all the rights and privileges of a company incorporated locally. The relationship between the home-office and branch is that between a manufacturer and a dealer—the former shipping goods to the latter which disposes of the product. This illustration may be amplified in that the branch may purchase additional goods locally or may manufacture part of the goods it sells. Sometimes a service department is also maintained. It is assumed that the manufacturer charges the branch for all goods shipped at the same prices he would charge an in-

dependent dealer, i. e., a discount from domestic list price, payment to be made in dollars against goods delivered at destination. Under these provisions the exchange difference existing when title to the goods passes to the branch forms part of the cost of the goods and must be borne by the branch. It follows that the branch manager must so arrange his local selling price that it covers the loss on exchange; in other words, the consumer must pay for the additional cost to the branch incurred in remitting dollars.

The cost of goods purchased from the home-office will, therefore, be expressed in local currency at the rate of exchange ruling at the time the goods were acquired, which in the illustration used, is the date of delivery at the branch. If the goods were paid for immediately under the terms assumed in this illustration, there would be no further loss on exchange to consider so far as the cost of goods purchased is concerned.

In practice an interval of time almost invariably elapses between the due date and the date on which remittance is made by the branch. As the exchange improves or declines in this interval the profit or loss resulting would be a financial item and would be shown as such in the profit-and-loss account, as distinct from the exchange difference which is incurred when the goods are acquired.

Theoretically, each purchase from the manufacturer should be converted at the current rates at the date of purchase and the inventory should be debited with these amounts and the home-office current account credited. At the end of the month the cost of the goods sold should be credited to inventory and charged to cost of sales account at the values at which the goods have been carried in the inventory. The liability to home-office and the inventory should be restated at the end of the month at the current rate ruling on the last day of the month and the debits or credits resulting should be carried to profit-and-loss as a financial gain or loss on exchange. If the net result of these two entries to profit-and-loss is a credit it would be sound practice to credit a reserve rather than to increase the profit for the month.

In practice, where a large number of transactions is involved, it will be found extremely laborious to treat with each on strictly theoretical lines, and abbreviated methods must

be adopted. To facilitate the reconciliation of the account between home-office and the branch it is desirable that the branch carry the current account in both dollars and local currency at the par or a fixed rate of exchange and the inventory of goods purchased from home-office on a similar basis. The current account and inventory are thus both understated where a depreciated currency is concerned.

Correctly to set forth the financial position of the local branch it becomes necessary therefore to carry two accounts for the inventory of goods purchased from home-office—the first being at the fixed rate, the second account representing the difference between value at current rate and the value at the fixed rate of exchange. The same principle is also applied in the case of the home-office account when the branch carries the account in both local currency at a fixed rate and the actual dollar liability to home-office, a second account being set up to cover the additional cost over the fixed rate to be incurred by the branch in remitting dollars.

In cases where the current account has been carried at a fixed or par rate of exchange, and the inventory has been valued on the same basis, it becomes necessary at some date to adjust the liability to home-office to the actual indebtedness. For instance, if the Italian branch owed home-office \$50,000 at the par rate of exchange, it would show on its books an indebtedness to home-office of lire 259,000. If we assume that the rate of exchange ruling at the date of the adjustment was twenty-five lire to the dollar the liability to home-office is actually lire 1,250,000, so that an additional liability to home-office must be set up for the difference, viz., lire 991,000, which will be carried in a separate account, entitled—say “home-office account, No. 2.” It will be appreciated that part of this liability will be represented by goods purchased from home-office and unsold at the date of this adjustment. The inventory is at the fixed or par rate in local currency and must therefore be increased to bring its value to the current rate; and in order to facilitate the accounting this increase is carried in a separate account entitled—say “Inventory account No. 2.” The difference between the adjustment in the “home-office account No. 2” and in the “Inventory account No. 2,” will be carried to surplus account. It is presumed that home-office has hitherto been carrying the

reserve necessary to adjust this condition in the consolidated balance-sheet, and it would be necessary to cancel this home-office reserve as the branch has now made the provision. At the end of each month or period subsequently both the current account and inventory of home-office goods will be refigured at the current rates ruling at the end of the period, and the local profit-and-loss account will be debited or credited, as the case may be.

I may mention that many complications can arise. For instance, it will sometimes be found that a branch has remitted more than is required and that the home-office actually owes the branch. Such a condition calls for special consideration as the branch in overpaying its account for purchases has been remitting profits or funds accumulated by the creation of reserves. In taking the loss on exchange on the amounts so remitted the branch has assumed a loss which should have been absorbed by the home-office. Remittances representing profits or funds other than for payment of purchases should be kept separately and the home-office should be charged with local currency, which it will credit at the rate ruling on the date of its receipt.

HOME-OFFICE ACCOUNTS

Consolidated balance-sheet—The investment by home-office in a branch which is a local company with limited liability will appear on the books of the parent company usually as (1) capital stock investment in the local branch company, (2) the amount owing by the branch for goods shipped and (3) advances to pay for fixed assets or other purposes. If the foreign business is solely a branch of the home-office the capital stock account is omitted. A fourth item appears in the consolidated balance-sheet, viz., the surplus or deficit of the local branch. It is often found that the fixed assets located abroad are carried on the home-office books at cost, but it would seem proper when local statements are required for tax or other purposes, that these should be carried in the branch books if proper deductions for depreciation, etc., are to be admitted to the local profit-and-loss account.

The general principles to be adopted in converting the assets and liabilities and profit-and-loss items are familiar, but it is perhaps as well to recite them here.

(1)—Convert fixed assets at rates ruling at time they were bought or average rate ruling for purchases within fiscal period. Where exchange fluctuations have been extreme in the period covered and the purchases heavy it would be safer to take actual rates ruling at dates of purchases or the average monthly rate ruling when purchases were made. These assets are for use in the business and they remain in the foreign country; consequently they do not vary with the current rate of exchange. In cases where there is extreme depreciation of the exchange rates from par this rule must not be followed too strictly and special cases must be dealt with individually. It should be kept in mind that present values of fixed assets from a branch viewpoint may be worth much more than would appear in local currency owing to increased cost of labor and material.

(2)—Convert current assets and liabilities at rates ruling on last day of period. In the case of the home-office account the branch will carry the dollar balance and the equivalent in local currency at current rate ruling at the end of period, the two current accounts with home-office described above enabling the conversion to be effected easily. The inventory of goods purchased from home-office is shown by the branch in dollars and the two inventory accounts combined will be at current rate of exchange. Current assets and liabilities should be shown at values which would arise if liquidation took place on last day of period.

(3)—Remittances will take the form of, first, payments for goods in dollars to home-office, the loss on purchase of these in the period being charged into the branch profit-and-loss account through the "home-office account No. 2"; next, payments representing profits will be in local currency and will be credited at their value ruling at the date of receipt, the home-office taking up the loss or profit involved, and, lastly, proceeds of sale of fixed assets or securities or other cash payments, not related to the current account for goods purchased, will be converted at actual rate of exchange on each transaction, the home-office taking up the loss.

(4)—Reserves will be converted at current rates where they are to provide for local contingencies. The reserve for depreciation of fixed assets should be converted at the same rate used in converting fixed assets.

(5)—Surplus at beginning of period will be converted at rate used at beginning of period and profit-and-loss entries at average rates ruling during period. If the period covered by the profit-and-loss account is an extended one, and the transactions were irregular and fluctuations in rates were marked, it would be more correct to use a weighted average rate. In organizations which make up monthly accounts, the average rate for each month is a fairer figure than the average for the year.

In reviewing the conversion of the various profit-and-loss items the difficult question arises at what rate the charges for depreciation on fixed assets should be converted. Under the plan of balance-sheet conversion outlined the fixed assets are converted at rates ruling at the time when they were purchased; it follows therefore that the depreciation should be converted on the same basis, otherwise the proper depreciation charge in local currency will have been set up on the branch books, while the converted amount of depreciation in the consolidated statements will have been understated.

Owing to the difficulty of continually adjusting the rate for the conversion of depreciation, however, the plan may be followed of calculating the depreciation in dollars on the dollar value of the fixed assets and using the amount so obtained in the place of the local currency amount converted at current rates.

The branch trial balance thus converted will not balance, and a debit or credit will be required to make it complete. It will be found frequently that a debit ensues, as in many branches the current assets have been partly financed by surplus accumulated in prior years and capital stock formerly represented by a current account, which was permanently capitalized at a previously higher rate of exchange. In this instance therefore the debit represents the loss on exchange on assets subject to fluctuation which are financed through surplus and capital stock, and a reserve has to be set up on home-office books to cover this shortage in values. In the consolidated statement the home-office reserve offsets the artificial debit on the converted branch trial balance.

If the branch has remitted profits, by payment of a dividend in the period, the exchange loss incurred at the time when the dividend is remitted must be taken up on home-

office books. For illustration, if a branch surplus was accumulated when exchange was at par and the local currency, at the beginning of the period, had depreciated, so far as the surplus was represented by assets subject to loss on exchange a reserve to cover this condition would have been set up on the home-office books. When the dividend is received by home-office this exchange reserve is debited with the loss and surplus is credited, the balance of the credit to surplus on account of this dividend coming through the cash account.

If the reserve on home-office books at the end of a given period is insufficient to meet the shortage on the branch-office trial balance after conversion, the profit-and-loss account must be charged and exchange reserve credited with difference, this being a home-office exchange loss due to depreciation of exchange rates on investment in current assets. I would mention here that in practice it is well to accumulate credits where possible and carry higher reserves than appear necessary at a given date, as the instability of rates even over a short period of time calls for conservative treatment.

Where surplus accounts have been permitted to stand on the books of the foreign subsidiary over an extended period, it is interesting to note that by converting the surplus at a rate prevailing at the end of the previous period the surplus account of the subsidiary may be stated much in excess of its real worth. This over-statement is however offset by the adjustment of the surplus of the parent company, which will have been reduced because the exchange reserve has been previously set up out of the home-office profits in previous years.

I should like to call attention to one other account which is important in dealing with the consolidated statement. Goods are usually charged to a branch at a price which will leave the home-office or manufacturer a small manufacturing profit. This means that the foreign branch-office inventories, when converted, are carried above actual cost of production in the United States and a reserve or adjustment account must be carried on the home-office books to bring the branch inventory to actual factory cost, for consolidated balance-sheet and profit-and-loss purposes. If consolidated monthly statements are prepared as promptly as possible after the closing date, it follows that the ascertainment of cost of sales must be

facilitated; hence the importance of showing the branch inventories of goods purchased from home-office separately from inventories purchased abroad and keeping these inventories on a dollar basis, as well as in local currency.

The subject of foreign-exchange accounting is a big one and I have skimmed the surface of one aspect of the situation only. The practical treatment of transactions in foreign currencies, where we are dealing with values which are fluctuating and uncertain, is much a matter of compromise. Further, the method to be adopted is dependent upon the nature and volume of transactions to be recorded; a system which would answer all reasonable requirements in some circumstances would in other cases be too abbreviated. In any event we must not allow our accounting recommendations to involve enormous detail in our endeavor to meet the requirements of theoretical perfection.

SUPPLEMENTAL MEMORANDUM, ILLUSTRATING
THE TREATMENT OF ENTRIES IN THE BOOKS
OF A FOREIGN SUBSIDIARY BRANCH
OFFICE AND THE CONSOLIDATION
OF ITS ACCOUNTS AT THE HOME
OFFICE

For the purpose of this example, the accounts are assumed to be those of a French subsidiary company. The rates of exchange used are as follows:

	<i>Fcs.</i>	\$
The fixed rate of exchange	5	1
The rate ruling at the beginning of the period	10	1
The average rate ruling during the period	9.50	1
The rate ruling at the end of the period	9	1

It is assumed that the branch is engaged in distributing the product of a manufacturer in the United States; further that the goods are charged to the branch at factory cost price. The statements illustrating the example may be summarized as follows:

Home-office Records

Statement showing consolidation of home-office and branch balance-sheets at beginning and end of period and treatment of

Treatment of Foreign Exchange in Branch-office Accounting

the more important transactions in home-office books which arise through trading with the branch in the period. (Statements A, B, C, D.)

Branch Records

Balance-sheet at beginning and end of period, journal and ledger. (Statements E, F, G, H.)

HOME OFFICE			A
CONSOLIDATED BALANCE-SHEET (WORKING SHEET)			
<i>January 1st (Beginning of period.)</i>			
<i>Assets</i>	<i>H. O.</i>	<i>French Branch</i>	<i>Consolidated Total</i>
Fixed assets	\$500,000.00	\$12,000.00	\$512,000.00
Inventories	200,000.00	10,000.00	210,000.00
Accounts receivable	150,000.00	4,000.00	154,000.00
Cash	25,500.00	2,000.00	27,500.00
Current account (French subsidiary) ..	9,500.00	9,500.00	
Capital stock (French subsidiary)	16,000.00	16,000.00	
Deferred charges	5,000.00	500.00	5,500.00
	906,000.00	3,000.00	909,000.00
 <i>Liabilities</i>			
Capital stock	600,000.00		600,000.00
Surplus	269,000.00	9,000.00	278,000.00
Reserve for foreign exchange	6,500.00	6,500.00	
Accounts payable	30,500.00	500.00	31,000.00
	906,000.00	3,000.00	909,000.00

HOME OFFICE			B
CONSOLIDATED BALANCE-SHEET (WORKING SHEET)			
<i>January 31st (End of period)</i>			
<i>Assets</i>	<i>H. O.</i>	<i>French Branch</i>	<i>Consolidated Total</i>
Fixed assets	\$500,000.00	\$12,000.00	\$512,000.00
Inventories	250,000.00	13,000.00	263,000.00
Accounts receivable	125,000.00	5,333.33	130,333.33
Cash	35,500.00	3,000.00	38,500.00
Current account (French subsidiary) ..	12,500.00	12,500.00	
Capital stock (French subsidiary)	16,000.00	16,000.00	
Deferred charges	4,000.00	555.55	4,555.55
	943,000.00	5,388.88	948,388.88
 <i>Liabilities</i>			
Capital stock	600,000.00		600,000.00
Surplus	270,000.00	8,000.00	278,000.00
Profit for period	15,666.66	1,000.00	16,666.66
Reserve for foreign exchange	5,388.89	5,388.89	
Accounts payable	51,944.45	1,777.77	53,722.22
	943,000.00	5,388.88	948,388.88

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HOME OFFICE CONSOLIDATED PROFIT-OR-LOSS STATEMENT FOR THE MONTH ENDED JAN. 31.

C

		<i>H. O.</i>	<i>French Branch</i>	<i>Consolidated Total</i>
Sales	\$300,000.00	38,000	\$4,000.00	\$304,000.00
Cost of sales	175,000.00	19,000	2,000.00	177,000.00
Gross profit	125,000.00	19,000	2,000.00	127,000.00
Expenses	110,000.00	10,000	1,052.63	111,052.63
Exchange loss or gain	666.66	500	52.63	719.29
Net profit carried to balance-sheet	15,666.66	9,500	1,000.00	16,666.66

HOME OFFICE ACCOUNTS AFFECTED BY FOREIGN EXCHANGE TRANSACTIONS IN PERIOD LEDGER

D

Surplus Account

Jan. 1 Balance	\$269,000.00
31 Cash a/c French dividend (journal entry No. 1)	555.55
31 Exchange reserve, portion of exchange reserve utilized on transfer a/c profits (journal entry No. 2)	444.45
	270,000.00

Reserve for Foreign Exchange

Jan. 1 Balance	6,500.00
31 French subsidiary dividend account (journal entry No. 2)	444.45
31 Profit or loss (journal entry No. 3)	666.66
Balance c/d	5,388.89
	6,500.00
Feb. 1 Balance b/d	5,388.89

Profit and Loss Account

Jan. 31 Reserve for foreign exchange (journal entry No. 3)	666.66
Assumed profit of domestic business for month	15,000.00
	15,666.66

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(1) Cash	555.55	
to surplus		555.55
being proceeds of dividend of 5000 fcs received when rate was 9 fcs to \$		
(2) Exchange reserve	444.45	
to surplus		444.45
being difference between amount actually received in cash for dividend and amount at fixed rate of exchange		

Treatment of Foreign Exchange in Branch-office Accounting

(3) Foreign exchange reserve	\$666.66	
to profit loss		\$666.66
To adjust the exchange reserve to amount required to cover loss on exchange on invest- ment in current assets other than for goods purchased from home office. (See converted branch balance-sheet statement F.)		

FRENCH BRANCH

E

BALANCE-SHEET, JAN. 1 (BEGINNING OF PERIOD)

<i>Assets</i>	<i>Francs</i>	<i>\$</i>	<i>Rate used in conversion</i>
Furniture, fixtures, real estate	60,000	12,000	5 fcs to \$
Inventory #1 (@ fixed rate 5 fcs to \$)....	50,000		
Inventory #2 (representing difference be- tween fixed and current rate) ..	50,000	10,000	10 fcs to \$
Cash	20,000	2,000	do
Accounts receivable	40,000	4,000	do
Deferred charges	5,000	500	do
	225,000	28,500	

Liabilities

Capital stock	80,000	16,000	5 fcs to \$
Surplus	45,000	9,000	do
Home-office account No. 1 (@ fixed rate of exchange)	47,500		
Home-office account No. 2 (representing dif- ference between fixed rate and current rate)	47,500	9,500	10 fcs to \$
Accounts payable	5,000	500	do
	225,000	35,000	

Difference Dr. \$6,500

FRENCH BRANCH

F

BALANCE-SHEET, JAN. 31 (END OF PERIOD)

<i>Assets</i>	<i>Francs</i>	<i>\$</i>	<i>Rate used in conversion</i>
Furniture and fixtures	60,000	12,000	5 fcs to \$
Inventory No. 1	65,000		
Inventory No. 2	52,000	13,000	9 fcs. to \$
Cash	27,000	3,000	do
Accounts receivable	48,000	5,333.33	do
Deferred charges	5,000	555.55	do
	257,000	33,888.88	

Liabilities

Capital stock	80,000	16,000	5 fcs. to \$
Surplus	40,000	8,000	do
Profit or loss (current year)	9,500	1,000	9.5 fcs. to \$
Home-office account No. 1	62,500		
Home-office account No. 2	50,000	12,500	9 fcs to \$
Accounts payable	15,000	1,777.77	do
	257,000	39,277.77	

Difference Dr. \$5,388.89

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FRENCH BRANCH

G

JOURNAL

1	Jan. 10	Inventory #1	\$15,000.00	
		To home-office account No. 1		\$15,000.00
		To record purchase of goods invoiced at \$3,000.00		
2	" 20	Inventory #1	10,000.00	
		To home-office account No. 1		10,000.00
		To record purchase of goods invoiced at \$2,000.00		
3	" 21	Home-office account No. 1	10,000.00	
		Home-office account No. 2	8,000.00	
		To cash		18,000.00
		To record payment of \$2,000 to home office @ lire 9.5 to the dollar		
4	" 31	Accounts receivable	38,000.00	
		To profit or loss account (sales)....		38,000.00
		To record sales for month of January		
5	" 31	Profit-and-loss account	19,000.00	
		To inventory No. 1		10,000.00
		To inventory No. 2		9,000.00
		To record cost of goods sold during month of January which is arrived at as follows:		
		Cost of goods sold \$2,000		
		@ fixed rate = fcs. 10,000		
		@ average rate for month		
		9.5 to the \$ = fcs. 19,000		
		Difference	9,000	
6	" 31	Cash	30,000.00	
		To accounts receivable		30,000.00
		To record receipts for month in settle- ment of customers' accounts		
7	" 31	Inventory #2	11,000.00	
		To home-office account #2		10,500.00
		Profit-and-loss		500.00
		To adjust inventory #2 and home- office account #2 as follows:		
		Inventory at end of month		
		\$13000 @ 9.5 to the dollar=117,000.00		
		Inventory #1—bal. 65,000.00		
		Inventory #2—bal. 41,000.00	106,000.00	
		Difference	11,000.00	
		Home-office account \$12,500		
		@ 9.5 to the dollar =112,500.00		
		Home-office account		
		#1	62,500.00	
		Home-office account		
		#2	39,500.00	102,000.00
		Difference	10,500.00	

The difference between the two above adjustments, viz. 500 fcs., represents a gain on exchange due to improvement in exchange rates since the beginning of the period.

Treatment of Foreign Exchange in Branch-office Accounting

8	Jan. 31	Surplus	\$5,000.00	
		To dividend account		\$5,000.00
		6¼% dividend on capital stock		
9	" 31	Dividend account	5,000.00	
		To cash		5,000.00
		Draft in favor of home office in pay- ment of dividend		
10	" 31	Profit-and-loss account (expenses)... ..	10,000.00	
		To accounts payable		10,000.00
		Expenses for the month		

FRENCH BRANCH

H

LEDGER

Accounts Receivable

			<i>Fcs.</i>	<i>Fcs.</i>
Jan.	1	Balance	40,000	
	31	Profit-and-loss (Sales) journal entry #4 ..	38,000	
	31	Cash journal entry #6		30,000
	31	Balance carried forward		48,000
			78,000	78,000
Feb.	1	Balance brought forward	48,000	

Deferred Charges

Jan.	1	Balance	5,000
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Capital Stock

Jan.	1	Balance	80,000
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Surplus

Jan.	1	Balance		45,000
	31	Dividend journal entry #8	5,000	
	31	Balance carried forward	40,000	
			45,000	45,000
Feb.	1	Balance brought forward		40,000

Home-office Account #1 (at fixed rate)

		\$	Fcs.	\$	Fcs.
Jan.	1	Balance		9,500	47,500
	10	Inventory account #1 journal entry #1		3,000	15,000
	20	Inventory account #1 journal entry #2		2,000	10,000
	21	Cash journal entry #3.....	2,000	10,000	
	31	Balance carried forward...	12,500	62,500	
			14,500	72,500	14,500
				72,500	72,500
Feb.	1	Balance brought forward		12,500	62,500

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FRENCH BRANCH				H1	
LEDGER					
Home-office Account #2					
		Fcs.	Fcs.		
Jan.	1	Balance		47,500	
	21	Cash journal entry #3	8,000		
	31	Sundries journal entry #7		10,500	
	31	Balance carried forward	50,000		
			<u>58,000</u>	<u>58,000</u>	
Feb.	1	Balance brought forward		50,000	
Accounts Payable					
Jan.	1	Balance		5,000	
	31	Profit-and-loss (expense) journal entry #10.		10,000	
	31	Balance carried forward	15,000		
			<u>15,000</u>	<u>15,000</u>	
Feb.	1	Balance brought forward		15,000	
Profit-and-loss Account					
Jan.	31	Accounts receivable journal entry #4		38,000	
	31	Inventory #1 and 2 journal entry #5.....	19,000		
	31	Sundries journal entry #7		500	
	31	Accounts payable #10	10,000		
	31	Balance carried forward	9,500		
			<u>38,500</u>	<u>38,500</u>	
Feb.	1	Balance brought forward		9,500	
Dividend Account					
Jan.	31	Surplus journal entry #8		5,000	
	31	Cash journal entry #9	5,000		
			<u>5,000</u>	<u>5,000</u>	
FRENCH BRANCH				H2	
LEDGER					
Furniture and Fixtures					
		Fcs.			
Jan.	1	Balance	60,000		
Inventory No. 1 Account (at fixed rate)					
		\$	Fcs.	\$	Fcs.
Jan.	1	Balance	10,000	50,000	
	10	Home-office account #1 journal entry #1	3,000	15,000	
	20	Home-office account #1 journal entry #2	2,000	10,000	
	31	Profit-and-loss journal entry #5			2,000
	31	Balance carried forward			13,000
			<u>15,000</u>	<u>75,000</u>	<u>15,000</u>
Feb.	1	Balance brought forward	13,000	65,000	

Treatment of Foreign Exchange in Branch-office Accounting

Inventory No. 2 Account

	<i>Fcs.</i>	<i>Fcs.</i>
Jan. 1 Balance	50,000	
31 Profit-and-loss journal entry #5		9,000
31 Sundries journal entry #7....	11,000	
31 Balance carried forward		52,000
	61,000	61,000
Feb. 1 Balance brought forward	52,000	

Cash

	<i>Fcs.</i>	<i>Fcs.</i>
Jan. 1 Balance	20,000	
21 Home-office account #1 and 2 journal entry #3		18,000
31 Accounts receivable journal en- try #6	30,000	
31 Dividend account journal entry #9		5,000
31 Balance carried forward		27,000
	50,000	50,000
Feb. 1 Balance brought forward	27,000	

The JOURNAL of ACCOUNTANCY

Official organ of the AMERICAN INSTITUTE OF ACCOUNTANTS

A. P. RICHARDSON, *Editor*

EDITORIAL

Restriction of Advertising

From the beginning of public accountancy as we know it today in this country it has been the constant effort of its leaders to establish their calling as a learned profession. All real friends of accountancy have had ever before them the hope and the expectation that the recognition which they themselves gave to the status of their vocation would extend to the business, financial and professional community. The time is long past when any doubt could be entertained as to the propriety of classifying a public accountant as a professional man. There are, of course grades of professional excellence, but it may be asserted beyond peradventure that the man or woman who offers to render professional accounting service to the public is entitled to classification as a member of a profession.

One fundamental difference between commercial and professional undertakings is the attitude of the participant toward his own activities. It is quite right and proper for a man of business to extol the wares which he has to sell. No one questions the good faith or ethical standing of a merchant who describes his merchandise in the highest terms compatible with truth.

The professional man on the other hand is selling his own innate and acquired abilities, and it is generally agreed that laudation of a man's personal qualifications, if not absolutely unethical, is certainly in bad taste. With this in mind, the members of the accounting profession have from the beginning sought to restrain personal advertisement. The subject is old and rather hackneyed. Hardly a meeting of accountants passes without comment and discussion upon some phase of the advertising question. All these discussions have been productive of good results. The wider and more comprehensive the discussion the better for all concerned.

It has, however, been extremely difficult to reach a conclusion, and many of those most opposed to advertising have been reluctant to attempt to force their opinions upon other members of the profession. Consideration has been protracted over many years; but everyone has recognized that we have been tending more and more to the time when there would be an actual rule inhibiting personal advertisement.

Now the expected has happened, and the rule has been adopted by the American Institute of Accountants.

The report of a special committee appointed in 1920 which reported to the institute in 1921 is directly responsible for the present enactment. The substance of that report was a recommendation that advertising should be prohibited. The report led to prolonged discussion at the annual meeting of 1921 and proponents and opponents, were given every opportunity to express their views in full. After discussion the following resolution was adopted:

“RESOLVED, That the committee’s report be approved and that it is the sense of this meeting that the publication or circulation of ordinary simple business cards, being a matter of personal taste or custom and convenience, is not improper, but solicitation of business by circulars or advertisements or by personal communications or interviews, not warranted by personal relations, is unprofessional and should not be permitted. It is desirable that the publication of books and articles on accountancy subjects should be encouraged to the fullest extent, but care should be taken that such publications do not contain self-laudatory expressions. If it deems it necessary the council is authorized to formulate rules for the guidance of the members to the end that a high standard of professional ethics and conduct shall be maintained.”

At the meeting of council of the institute held in April, 1922, it was resolved that the committee on professional ethics should be directed to prepare a rule in accordance with the foregoing resolution. The rule thus called for was presented at the meeting of council of the American Institute of Accountants held September 18, 1922, and was adopted. Subsequently, the action of the council in adopting the rule was approved by the institute at its meeting of September 19th.

The rule reads as follows:

"No member or associate of the Institute shall advertise his or her professional attainments or services through the mails, in the public prints, or by other written word; but any member or associate may cause to be published in the public prints or otherwise, what is technically known as a "card." A card is hereby defined as an advertisement of the name, title (member of American Institute of Accountants, C. P. A., or other professional affiliation or designation), and address of the advertiser without further qualifying words or letters; or in the case of announcements of change of address or personnel of firm the plain statement of the fact for the publication of which the announcement purports to be made. Cards permitted by this rule when appearing in newspapers shall not exceed two columns in width and three inches in depth; when appearing in magazines, directories and similar publications, cards shall not exceed one quarter page in size. This rule shall not be construed to inhibit the proper and professional dissemination of impersonal information among a member's own clients or personal associates, or the properly restricted circulation of firm bulletins containing staff personnel and professional information."

This rule, which becomes No. 12 of the rules of professional conduct, was prepared by the committee on professional ethics after careful consideration and drafting and redrafting. It is believed by the committee that it covers the requirements of the case adequately. It will be noted that the so-called "card", for which some accountants still maintain a fondness, is not forbidden. As we interpret the rule, it is prohibitive of personal praise. If that be the correct interpretation, we fail to see how there may be serious objection to its enforcement. However, the rule has been adopted, and is now embodied in the code of the institute.

Chapters

When the American Institute of Accountants was founded in 1916, various matters not included in the constitution and by-laws were omitted in the belief that their consideration would be better postponed until the institute was more firmly established. Among these questions was the formation of state or local organizations to consist of members of the institute. Such sub-

sidiary groups, usually described as chapters, were strongly favored by many members of the institute, and for some years there has been a committee considering the whole question and making recommendations from time to time looking toward the permission to create local chapters if the members of the institute residing in any given district so desired.

Difficulties have been met, chiefly because of the problem arising in states where there are already strong state societies many of the members of which are not members of the institute. These difficulties, however, seem to have been largely overcome by the general agreement that any form of chapter organization should be optional. If the accountants in any section desire to form a chapter, the thought was expressed that they should be permitted so to do.

Finally the matter reached a definite conclusion in the adoption of an amendment of the constitution of the institute at the annual meeting held last month. All amendments to the constitution or by-laws of the institute before becoming effective must be approved in writing by a majority of the voting members, and it is therefore possible that the amendment adopted at the meeting may not be ratified by the membership. The possibility, however, is somewhat unlikely.

The amendment provides that article V of the constitution shall read as follows:

"CHAPTERS

"Upon application to the council of the Institute and subject to its approval, there may be organized in any state, by members resident or having a place of business therein, a subsidiary body to be known as a chapter of the American Institute of Accountants under such rules and regulations as the council of the Institute may prescribe."

The present articles V and VI of the constitution then become articles VI and VII, respectively.

This amendment, if finally ratified, should provide ample opportunity for the creation of chapters wherever members wish to have them. The provisions are sufficiently liberal to allow a good deal of diversity in the actual form of chapter organizations and will probably meet with the approval of all who have the chapter idea at heart.

Income-tax Department

Edited by Stephen G. Rusk

A decision recently handed down by Judge Anderson of the United States circuit court of appeals is embodied in treasury decision No. 3368, published in this month's issue of *THE JOURNAL OF ACCOUNTANCY*. This decision appertains to the subject of whether or not certain corporate bodies are subject to the capital-stock tax under the revenue acts of 1916 and 1918. The appealing taxpayers sought to be classed as "Massachusetts trusts" or trusts, rather than associations. The court has written a comprehensive and lucid definition of what must be present if a taxpayer is to be considered a trust, and if this decision is read after a reading of solicitor's memorandum No. 1068, the court's reasoning in the present cases becomes clear and his conclusions logical. Solicitor's memorandum No. 1068 reads as follows:

"Where beneficiaries holding certificates evidencing their interest under a so-called 'Massachusetts trust' agreement annually elect persons delegated to conduct the affairs of the trusts, thus retaining a voice in the business, the trust is an association and is subject to normal tax upon its income under the acts of 1913, 1916 and 1918; the excess profits tax under the acts of 1917 and 1918; the capital stock tax under the acts of 1916 and 1918; and the certificates issued by the trust to the beneficiaries are subject to the stamp tax under the acts of 1917 and 1918.

Where the trustees originally appointed were to hold office during the entire period of the trust, the right of the shareholders being limited to filling vacancies, the beneficiaries not retaining any substantial control over the affairs of the trust, such a trust is not an association or taxable as such under section 230 of the act of 1918, but under section 219 relating to trusts. They are not subject to the excess profits tax nor the capital stock tax, nor are the certificates issued by the trustees subject to stamp tax."

The court also has something to say with reference to non-par stock which it would be well to add to one's information upon that subject.

Another decision published this month deals with the subject of depletion of oil and gas properties. This decision (No. 3386) amends the language of article No. 170 of 1916 regulations No. 33. This is rather ancient, but is published for the benefit of those who may still have controversies with the government upon taxes under the revenue act of 1916.

TREASURY RULINGS

(T. D. 3368, July 12, 1922.)

Capital stock tax—Revenue acts of 1916 and 1918—Decision of court.

1. TAX STATUTES—RULE OF CONSTRUCTION.

While, in applying tax statutes, reasonable doubt must be resolved in favor of the taxpayer, revenue acts are not penal statutes; the government is not to be crippled by strained and unnatural construction of tax statutes fairly plain.

2. SAME.

When language used in an earlier statute has in application received judicial construction, change in language in later analogous legislation imports legislative purpose to attain a different result.

3. ASSOCIATIONS—TAXABILITY OF NONSTATUTORY ASSOCIATIONS—CONSTRUCTION OF REVENUE ACTS OF 1916 AND 1918.

The contrast between the language used in the act of August 5, 1909, imposing a tax on every joint-stock company or association "organized

under the laws of the United States," etc., and in the revenue acts of 1916 and 1918, which imposed a capital stock tax upon associations "organized in the United States," shows that Congress intended to avoid the effect of the holding in *Elliott v. Freeman* (220 U. S. 178), that the 1909 act did not cover certain Massachusetts trusts because limited to organizations deriving some power or benefit from statute. Therefore, non-statutory associations are subject to the capital stock taxes imposed by the revenue acts of 1916 and 1918.

4. MASSACHUSETTS TRUSTS—TAXABILITY AS "ASSOCIATIONS"—CONSTRUCTION OF REVENUE ACTS OF 1916 AND 1918.

Section 407 of the revenue act of 1916 and section 1000 (a) of the revenue act of 1918, imposing an excise tax measured by the value of the capital stock of associations, include business organizations known as Massachusetts trusts, where the shareholders or beneficiaries have power to control the trustees.

5. SAME—NO PAR VALUE OF STOCK, EFFECT OF.

Whether the stock of a corporation, of an association, or of a joint-stock company, has or has not par value is immaterial in determining liability for the capital stock tax imposed by the revenue acts of 1916 and 1918, since stockholders own beneficially the net value of the corporation's assets, whether a definite value is or is not attributed to their shares, severally or in mass.

6. SAME—GENERAL PURPOSE OF CONGRESS.

The manifest general purpose of Congress, in imposing a capital stock tax by the revenue acts of 1916 and 1918, was to tax business deriving powers and making profits from association, particularly business done by organizations getting all or a substantial part of their capital on transferable shares, such as are commonly sold to the investing public.

7. MASSACHUSETTS TRUSTS—EFFECT OF ENACTMENT BY MASSACHUSETTS LEGISLATURE.

The Massachusetts Legislature, by acts passed prior to the passage of the revenue acts of 1916 and 1918, expressly recognized Massachusetts trusts as associations, not as trusts or partnerships; congress must be held to have used the word "association" as the Massachusetts legislature had previously defined and used it.

8. SAME.

By act of 1916, chapter 184, the Massachusetts legislature made Massachusetts trusts liable to creditors in like manner as if corporations; by analogy they have similar liability to the federal government for taxes.

9. SAME—PRIOR DECISIONS.

Malley v. Bowditch (259 Fed. 809) followed and *Crocker v. Malley* (249 U. S. 223) distinguished.

The appended decision of the United States circuit court of appeals for the first circuit, in the cases of *Malley, former collector, v. Howard et al., trustees; Casey, acting collector, v. Howard et al., trustees; Malley, former collector, v. Crocker et al., trustees; and Malley, former collector, v. Hecht et al., trustees*, is published for the information of internal revenue officers and others concerned.

UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIRST CIRCUIT. OCTOBER TERM, 1921.

No. 1551. *John F. Malley, formerly collector of internal revenue, defendant, plaintiff in error, v. Arthur L. Howard et al., trustees, plaintiffs, defendants in error.* No. 1552. *Andrew J. Casey, acting collector of internal revenue defendant, plaintiff in error, v. Arthur L. Howard et al., trustees, plaintiffs, defendants in error.* No. 1553. *John F. Malley, formerly collector of internal revenue, defendant, plaintiff in error v. Alvah Crocker et al., trustees, plaintiffs, defendants in error.* No. 1554. *John F. Halley, formerly collector of internal revenue, defendant, plaintiff in error, v. Louis Hecht jr., et al., trustees, plaintiffs, defendants in error.*

ERROR to the District Court of the United States for the district of

BEFORE BINGHAM, JOHNSON, AND ANDERSON, Judges.

OPINION OF THE COURT.

[June 6, 1922.]

ANDERSON, judge: These cases involve the validity of taxes imposed upon business organizations, commonly known as Massachusetts trusts, under the revenue acts of 1916 (39 Stat. 789) and 1918 (40 Stat. 1057). Nos. 1551 and 1552 involve the Haymarket Trust and we treat them as one case. The cases were argued as a group and may be conveniently dealt with in one opinion.

The chief business of the Haymarket and Hecht trusts is that of owning, managing, and leasing real estate, and distributing the net income to its shareholders. These concerns deny that they are associations within the meaning of the statutes.

The Crocker trust is a large manufacturing concern. It admits that it is an association within the meaning of the statutes, but it claims immunity from the tax on the ground that it has no capital stock within their meaning.

The court below sustained the plaintiff's contentions in each case, and the government brought the cases here on writs of error.

The fundamental question is whether the plaintiffs are associations having a capital stock represented by shares, within the meaning of these provisions. So far as the issues in these cases are concerned, the provisions of the two statutes seem to us to be equivalent, for there is now presented no controverted question as to the amount of any tax; we therefore need not consider the different amounts exempt under the two statutes or the retroactive and substitutional effect of the 1918 statute.

The act of 1916 levies a tax on associations "now or hereafter organized in the United States for profit and having a capital stock represented by shares * * * with respect to the carrying on or doing business by such * * * association * * * equivalent to 50 cents for each \$1,000 of the fair value of its capital stock, and in estimating the value of capital stock the surplus and undivided profits shall be included. * * * The amount of such annual tax shall in all cases be computed on the basis of the fair average value of the capital stock for the preceding year"—with an exemption not now material.

The act of 1918, section 1, includes associations under the term "corporation;" and in section 1000 (a) provides for an annual "special excise tax with respect to carrying on or doing business equivalent to \$1 for each \$1,000 of so much of the fair average value of its capital stock for the preceding year," etc. "In estimating the value of capital stock the surplus and undivided profits shall be included."

Both acts are conceded to levy an excise tax with respect to doing business, the amount of the tax being measured by the average value of the capital stock, including any surplus and undivided profits as a part thereof. All the plaintiffs agree that they are doing business within the meaning of these acts.

While we recognize that in applying this and every other tax statute reasonable doubts must be resolved in favor of the taxpayer (*Gould v. Gould*, 245 U. S. 151) yet revenue acts are not penal statutes; the government is not to be crippled by strained and unnatural construction of tax statutes fairly plain—*Cliquot's Champagne* (3 Wall. 114, 115); *United States v. Hodson* (10 Wall. 395); *Worth Bros. v. Lederer* (251 U. S. 507).

Taxation of this general kind began with the passage of the act of August 5, 1909 (36 Stat. 11, 112), which imposed a tax "on every corporation, joint-stock company, or association organized for profit and having a capital stock represented by shares * * * now or hereafter organized under the laws of the United States or of any State or Territory * * * with respect to the carrying on or doing business by * * * such corporation, joint-stock company, or association * * * equivalent to 1 per cent upon the entire net income over and above \$5,000," etc.

This statute, passed before we had the sixteenth amendment, was attacked as an income tax and therefore unconstitutional. But the supreme court held that it was not an income tax, and sustained it as an excise tax—*Flint v. Stone Tracy Co.* (1911), (220 U. S. 107). It was measured by the income, not as under the present law, on the capital used.

In *Eliot v. Freeman* (220 U. S. 178), the court at the same time held the act of 1909 not to cover two typical Massachusetts real estate trusts, on the ground that "the language of the act, 'now or hereafter organized under the laws of the United States,' etc., imports an organization deriving power from statutory enactment." Organized as purely nonstatutory, they were exempt.

The gist of the present case is whether the statutes of 1916 and 1918 are, as the plaintiffs contend, to be given the same interpretation in favor of exempting such organizations as was given by the supreme court to the act of 1909.

The government, on the other hand, contends that the language of the acts is plainly applicable to such organizations; that the history of the legislation shows that congress intended to avoid the result reached in *Eliot v. Freeman*, supra, and that there are no applicable decisions of the courts supporting the plaintiffs' position. We think the government is right, and that the court below erred in holding that such organizations are not associations within the meaning of these revenue acts.

The language of the statutes, supra, seems so plain that repetition and paraphrasing would add nothing.

The history of the legislation lends emphasis to the initial impression of its import. For it is elementary that when language used in an earlier statute has in application received judicial construction change in language in later analogous legislation imports legislative purpose to attain a different result. If congress had intended the acts in question to have the restricted application given by the supreme court to the act of 1909, there was no conceivable reason for changing the words "*organized under the laws of the United States or of any State,*" etc., etc., to "*organized in the United States.*"

We think it plain that by this change congress intended in the later acts to include nonstatutory organizations and to avoid the restriction found by the supreme court in the words of the 1909 act. We can not accord with the learned district judge in his view that "it is hard to discover any substantial distinction between the scope of" the act of 1909 and the acts of 1916 and 1918 "as far as 'associations' are concerned." We think there is a vital and controlling distinction.

Eliot v. Freeman was decided in 1911. In 1913 an income tax act was passed (38 Stat. 114, 166), imposing such tax "on every corporation, joint-stock company, or association, and every insurance company organized in the United States, no matter how created or organized, not including partnerships." The original case of *Crocker v. Malley* (249 U. S. 233), the plaintiffs' chief reliance, arose under this statute. Sitting as district court, Judge Bingham, in July, 1917, held the Wachusett Realty Co., the predecessor of the present Crocker Association, a trust, according in that regard with Judge Hale in a decision made on May 23, 1914, in the case of *Crocker v. Crocker*.

But in this court (250 Fed. 817) the organization was held an association within the meaning of the statute. The supreme court reversed this court, adopting the view of the district court. The decisions, both in the supreme and district courts, against the government, turned upon the fact that the shareholders had no real control over the trust estate; so that it therefore fell within the doctrine of *Williams v. Milton* (215 Mass. 1), from the opinion in which Mr. Justice Holmes quoted (249 U. S. 223, 232) as follows:

There can be little doubt that in Massachusetts this arrangement would be held to create a trust and nothing more. "The certificate holders * * * are in no way associated together, nor is there any provision in the [instrument] for any meeting to be held by them. The only act which (under the [declaration of] trust) they can do is to consent to an alteration * * *

of the trust" and to the other matters that we have mentioned. They are confined to giving or withholding assent, and the giving or withholding it "is not to be had in a meeting, but is to be given them individually." "The sole right of the cestius que trust is to have the property administered in their interest by the trustees, who are the masters, to receive income while the trust lasts, and their share of the corpus when the trust comes to an end."

The trustees of the Wachusett concern held title, subject to a long lease, to eight mills and to the stock of the corporation operating these mills, and distributed the net income to the eight beneficiaries of the trust. The trustees were not managing the mills; the organization was not a business enterprise within the normal use of that term. The beneficiaries were "admitted not to be partners in any sense * * * have no joint action or interest and no control over the fund." (249 U. S. 234.)

The court, in referring to the phrase in the statute "no matter how created or organized," says:

The trust that has been described would not fall under any familiar conception of a joint-stock association, *whether formed under a statute or not*. Citing *Smith v. Anderson* (15 Ch. Div. 247, 273, 274, 277, 282).

Moreover, the tax then sought to be sustained was levied, at least in substantial part, in respect of dividends received from a corporation that itself was taxable upon its net income. The court therefore held that "as the plaintiffs undeniably are trustees, if they are subjected to a double liability, the language of the statute must make the intention clear."—*Gould v. Gould* (245 U. S. 151, 153).

It is thus apparent that the Wachusett Realty Co. was in organization and purpose but an ordinary inter vivos trust for eight beneficiaries; also that the tax sought to be imposed would have resulted in double taxation, never easily inferred. It was in nature, and in relations to its shareholders and to society at large, radically different from the plaintiffs' organizations described below. That decision lends no support to the plaintiffs' contention.

Next in chronological order was the stamp tax provision of the act of October 22, 1914 (38 Stat. 745, 775). This act imposed a stamp tax on "each original issue * * * of certificates of stock by any *association, company, or corporation*." This court in *Malley v. Bowditch* (259 Fed. 809) held such tax applicable on the original issue of certificates or shares of the Pepperell Manufacturing Co., "a manufacturing company organized in the form of a trust under the common law and deriving none of its rights, qualities, or benefits from any statute." The crucial question in that case, as in the case at bar, was whether the organization was an association within the meaning of the Federal tax act. The case is, in essentials, difficult, if not impossible, to distinguish from the cases at bar. The cogent opinion of Judge Brown is applicable to most aspects of the present problem. It might well be quoted from at length.

The revenue acts of 1916 and 1918, *supra*, both in their income and excise tax provisions, adopt the same broad phrasing as to joint stock companies or associations "organized in the United States," thus showing a continuing legislative purpose to avoid the limitation found by the supreme court in *Eliot v. Freeman*, *supra*, arising out of the language "*organized under the laws of the United States or of any State*," etc.

Plainly, there is nothing in this history of legislative and judicial dealing with the matter lending support to plaintiffs' contention that congress intended to exempt such business organizations as the plaintiffs. Rather does the history support the natural construction of the acts in question.

We find nothing else in the history of the legislation concerning this and analogous forms of taxes, nor in other cases cited, tending to uphold the plaintiffs' contentions or otherwise calling for analysis and discussion.

A brief description of the three plaintiffs' organizations will conveniently precede our final considerations. We take first the Hecht case, agreeing with learned counsel that it is the strongest case for the plaintiff.

On superficial examination, this organization looks somewhat like a family affair, making provision for members of the Hecht family, immature or

otherwise unfitted for business responsibilities. But on analysis we find the organization is a very genuine business concern.

In 1899, members of the Hecht family holding as tenants in common real estate on Federal Street and Atlantic Avenue, Boston, conveyed it to Jacob Hecht, who declared a trust for 12 beneficiaries all named Hecht, who received certificates transferable like ordinary corporation shares, but with a restriction in favor of lineal descendants of Elias Hecht, and, on certain contingencies not now important, to be offered to the trustee before sold to an outsider. The restriction is analogous to the close corporation provision dealt with in *New England Trust Co. v. Abbott* (162 Mass. 148). It is in no way peculiar to a trust as distinguished from a corporation. While the Hecht trustee has broad general powers of management, including power to buy and sell, the seat of real power is with the shareholders and not with the trustee; for three-fourths of the shareholders may remove the trustee, three-fifths may terminate the trust or give him binding instructions, and also—what is of vital importance—*modify the instrument in any particular*. This power to modify covers, potentially, the right to extend or change the business so as to make it as large and as corporate in form and function as the Crocker concern, which admits that it has evolved into an association. The Hecht organization is not a trust within the doctrine of the Massachusetts decisions.—*Williams v. Milton* (215 Mass. 1). Compare *Crocker v. Malley* (249 U. S. 223); *in re Associated Trust*, (222 Fed. 1012). The Hecht trustee has made annual statements showing the assets, liabilities and net income, and kept books, containing a capital account and surplus account. Its stockholders have, sensibly and we think legally, treated their dividends like corporation dividends in their income tax returns. They have thus by conduct, presumably under the advice of counsel, denied that they are partners taxable under the act of 1918 (sec. 218 (a)).

Parenthetically, we note that counsel do not contend that the shareholders of any of these plaintiff associations are partners. There is no suggestion that any of the shareholders in any of the plaintiff organizations have made, propose to make, or could make, tax returns as partners in these business concerns. Manifestly, counsel would deprecate such result as imposing burdens probably much heavier—certainly difficult if not impossible of ascertainment—upon the shareholders in such organizations. Their quest is tax exemption, not tax substitution. Compare *Dana v. Treasurer* (227 Mass. 562, 565); *Frost v. Thompson* (219 Mass. 360).

Plainly, the Hecht Trust is quasi-corporate in form and power. It is an association within the meaning of the revenue acts.

The Haymarket Trust, both in genesis and organization, is even more like a corporation. It has none of the aspects of a family affair. It started by securing from the investing public \$250,000 on solicited subscriptions, the trustee paying a commission of \$2,500 to the promoter for thus raising the capital for doing business. The declaration of trust provides for nearly all the machinery and proceedings of an ordinary corporation. We hold it also to be quasi-corporate and an association within the meaning of the revenue acts.

Learned counsel in the Crocker case admit that it is an association but claim exemption on the ground that the concern has no capital stock. This association was evolved from the Wachusett Realty Trust, above referred to. As there pointed out, the shareholders had under the Wachusett declaration no power to amend without the assent of the trustees. But in June, 1917, shareholders and trustees both agreeing, the organization was radically altered. Its name was changed and in express terms it agreed that its form should thereafter be "changed to that of an association," with power to take over and carry on the extensive manufacturing business previously carried on by the corporation whose stock it had held, or any substantially similar business.

The new organization conforms closely to the corporation model—in powers, in official personnel, and in methods of doing business. It has issued 96,000 shares of no par value, transferable like corporation stock, but with

a restriction somewhat like that in the case of *New England Trust Co. v. Abbott*, supra.

Conceding that it is an association with transferable shares, this plaintiff yet seeks exemption on the ground that it has attached no par value to its 96,000 shares. It admits that if it had attached a par value of, say, \$100 to each of these shares, making a capital account of \$9,600,000, a little less than is shown on its balance sheet of July 1, 1917, where the interest of the shareholders is put down as \$9,877,105.16—the concern would have had a capital stock represented by shares, and thus be an association within the meaning of the revenue acts, supra.

We can not adopt this scholastic and artificial distinction. Cf. *Worth Bros. v. Lederer* (251 U. S. 507, 510). It is for present purposes immaterial whether the stock of a corporation, of an association, or a joint-stock company has or has not par value. Compare *General Laws of Massachusetts* (ch. 156, secs. 14, 15, 47). Stockholders, whether a definite value is or is not attributed to their shares, severally or in mass, own beneficially the net value of the corporation's assets—that is, whatever may remain after discharging debts.

See *Hood Rubber Co. v. Commonwealth* (238 Mass. 369, 371). Cook—"Stock Without Par Value," *American Bar Association Journal*, October, 1921; Hollen and Tuthill, "Stock Having No Par Value," *American Bar Association Journal*, November, 1921, page 578; Colton, "Par Value v. No Par Value Stock," *American Bar Association Journal*, December, 1921, page 671.

Compare also *Eisner v. Macomber* (252 U. S. 189, 209 et seq.).

Congress intended that this tax should be measured by the average amount of capital used during the tax year in doing the business. The phrase in the statutes as to "including surplus and undivided profits" puts beyond doubt the question of the congressional intent to measure this tax by business and financial realities, not by bookkeeping forms or mere names. "Fair value" and "fair average value" carry the same notion. Cf. *Wright v. Georgia R. R. et al.* (216 U. S. 420, 424, 425).

The Crocker Association can not escape taxation, falling on its competitors, by adopting the modern theory of no par value for its stock. The presumption is against such immunity; it savors of special privilege. Compare *United States v. Dickson* (15 Pet. 141, 165).

It is a matter of common knowledge that, for most business and financial purposes, all the larger organizations of this sort have for years been indistinguishable from corporations. One might almost say that they are a device under which parties make their own corporation code. Business concerns so organized have come to occupy a large field in industry and in finance. At least two substantial textbooks have been written on the law concerning such organizations and dealing with their advantages for general business purposes. See *Sears, Trust Estates as Business Companies* (1st ed. 1912, 2d ed. 1921). Note the long list of industries so organized referred to on pages VI and VII of the preface of the 1921 edition. See *Wrightington on Unincorporated Associations*, 1916. In *Dana v. Treasurer* (227 Mass. 562, 565) it appears that the Amoskeag Manufacturing Co., commonly known to be one of the largest enterprises in New England, is so organized. The Pepperell Manufacturing Co., before this court in *Malley v. Bowditch*, supra, had a capitalization of over \$7,500,000; the Crocker Trust operates large paper-manufacturing mills, employing about 1,000 men, with gross assets of over \$10,000,000.

Such concerns have long been recognized as quasi corporate in form. In 1904 Chief Justice Knowlton in the Massachusetts supreme court said of a typical one of them, in *Hussey v. Arnold* (185 Mass. 202):

The agreement creating the trust has peculiar provisions. The object of it apparently was to obtain for the associates most of the advantages belonging to corporations, without the authority of any legislative act, and with freedom from the restrictions and regulations imposed by law upon corporations.

No amplification of words could more accurately and adequately characterize this sort of business organization. Other cases in the Massachusetts reports concerning them abound in similar observations as to their resemblance to corporations—*Williams v. Milton* (215 Mass. 1) and cases cited. See *Williams v. Boston* (208 Mass. 497); *Phillips v. Blatchford* (137 Mass. 510, 515); *Tyrrell v. Washburn* (6 Allen, 466, 474).

But the proposition that they are quasi corporate in form need not rest merely on our own analysis or on observations found in the decisions of the Massachusetts courts. It has now been distinctly recognized by the Massachusetts legislature; they have a statutory status as *associations*, not as trusts or as partnerships.

In the decision below these organizations have been treated as having no status not arising out of the common law; so also in the briefs of the government and of counsel for the defendant. It seems to have been overlooked that they have acquired in Massachusetts a distinct statutory basis. This, if the question before us were otherwise doubtful, would seem to us of much significance. See *General Laws of Massachusetts*, 1921 (ch. 182), codifying earlier legislation of 1909, 1913, 1914, 1915, and 1916. Compare also acts of 1921 (ch. 368). The title of this chapter is "*Voluntary Associations*."

In section 1 of this act, dealing with definitions, it is provided:

"Association," a voluntary association under a written instrument or declaration of trust, the beneficial interest under which is divided into transferable certificates of participation or shares.

This definition exactly fits the plaintiffs at bar.

In section 2 it is provided that the written instrument or declaration creating the association shall be filed with the commissioner of corporations, and with the clerk of every town where such association has a usual place of business. Section 5 requires the commissioner to transmit to the secretary of state copies of such instruments or of any amendments filed during the previous year, to be printed as a public document. The instruments creating such associations are thus made even more generally accessible than are ordinary corporation charters.

Sections 3 and 4 and 7 to 11 deal specially with associations owning stock of public utility companies; they need no present comment.

Section 6—a reenactment of the act of 1916, chapter 184, passed subsequent to all the Massachusetts decisions cited and relied upon by the plaintiffs—has probably the most direct bearing on our present problem. It is as follows:

An association may be sued in an action at law for debts and other obligations or liabilities contracted or incurred by the trustees, or by the duly authorized agents of such trustees, or by any duly authorized officer of the association, in performance of their respective duties under such written instruments or declarations of trust, and for any damages to persons or property resulting from the negligence of such trustees, agents or officers acting in the performance of their respective duties, and *its property shall be subject to attachment and execution in like manner as if it were a corporation*, and service of process upon one of the trustees shall be sufficient.

Here is a distinct enactment that such *associations* shall be suable *in like manner as if corporations*. An organization described as an *association* and made generally liable "to attachment and execution in like manner as if it were a corporation" can not easily be held a partnership or a trust.

We are not called upon to deal with the confusing and perhaps irreconcilable decisions of the Massachusetts courts concerning the nature and legal incidents of these associations, most of which were made before the passage of this act of 1916, or with the effect of this legislation upon their powers and liabilities—except so far as pertains to our single problem of determining whether these associations are liable to Federal taxation under the revenue acts, *supra*. We intimate no opinion on any other question. But when a Massachusetts statute has described such organizations as *associations*, and have put their liability to ordinary creditors apparently on the same basis as

that of corporations, we have no hesitation in reaching the conclusion that they have now been given a *statutory basis as quasi-corporate*, and that they are associations within the meaning of the federal statutes, as well as under the Massachusetts statutes. We can not hold Massachusetts *associations*, liable under Massachusetts statutes to ordinary creditors as though corporations, not liable under federal statutes to taxation imposed generally on corporations, joint-stock companies, and *associations*.

It may be argued that these statutes are distinguished from corporation acts in that their chief functions are to regulate or restrict, whereas corporation acts also empower. Technically, that may be so. But the powers of these voluntary associations are in many respects greater, and the regulations and restrictions less, than in the case of corporations. Broadly speaking, their promoters select and define such powers and provide such limitations of liability as they desire. Cf. *Hussey v. Arnold*, supra. If and in so far, therefore, as the tax in question is directed at "the privilege" or power of doing business through large organizations—and particularly at the power to obtain money from the outside public on transferable shares—voluntary association offers at least as much "privilege" as does any corporation form of organization. Associations are resorted to, not because thought weaker, but because thought stronger than corporations.

If, in constructing the statutes, we may look at the policy congress probably desired or adopt, it could not be overlooked that the plaintiff contention, if sustained, would amount to a discriminatory immunity in favor of a kind of business organization, the nature and activities of which have hitherto been the subject of much question and investigation. See the *Report of the Tax Commissioner of Massachusetts on Voluntary Associations*, under resolves of 1911, chapter 55—a very interesting document—in which Commissioner Trefry ably reviewed their origin, history, and legal incidents, both in England and in this country; referring, passim, and particularly on page 13, to many other documents and legislative reports concerning them. See also a report of the special commissions to investigate voluntary associations, January, 1914, made under Massachusetts Resolves of 1912, chapter 113. In the resolve of 1911, chapter 55, the commissioner was required to make an investigation, "with a view to determine" inter alia, "whether * * * their prohibition * * * is advisable in the public interest."

There is, we think, no conceivable reason why congress should have desired to favor organizations of this questioned sort by exempting them from taxation to which their competitors in corporate form are subjected. The presumption is plainly the other way. Modern corporation laws furnish adequate machinery for carrying on every legitimate form of business, including now that of dealing in real estate. See *General Laws of Massachusetts* (ch. 156, passim, sec. 7), authorizing real estate corporations. There is no present reason for resorting to this form of organization, except on the theory that more "privileges of doing business" may be thus acquired than by conforming to our broad and elastic corporation laws. To hold that congress intended to discriminate in their favor would be to disregard the letter, the spirit, and the reason of the acts.

Our views accord with those expressed by Judge Page in *Chicago Title and Trust Co. v. Smietanka* (275 Fed. 60). The reasoning of Judge Morton in the *Associated Trust* case) 222 Fed. 1012), where he reached the conclusion that such an association was an "unincorporated company" within the meaning of the bankruptcy act, seems to us to sustain our conclusions rather than those reached by the learned judge in the instant cases.

We may summarize our conclusions as follows:

(1) The natural interpretation of the language used in the acts of 1916 and 1918 would include plaintiffs' organizations as associations.

(2) The contrast between the language used in the act of 1909 "organized under the laws of the United States or any state," etc., and in the acts of 1916 and 1918 "organized in the United States," shows that congress intended to avoid the result reached in 1911 by the supreme court in *Eliot v. Freeman*.

(3) The manifest general purpose of congress was to tax business deriving powers and making profits from association, particularly business done by organizations getting all or a substantial part of their capital on transferable shares, such as are commonly sold to the investing public.

(4) Prior to the passage of either the revenue act of 1916 or 1918, the Massachusetts legislature had by the acts of 1909 and 1914 expressly recognized such organizations as associations. Congress used the word "association" as the Massachusetts legislature had previously defined and used it.

(5) By the act of 1916, the Massachusetts legislature made such associations liable to creditors in like manner as if corporations; by analogy they have similar liability to the federal government for taxes.

(6) The case of *Malley v. Crocker* (249 U. S. 223) makes, on analysis of the Wachusett Trust and the reasoning of the court, not for the plaintiffs but for the government. One ground of that decision was to avoid unjust, discriminatory double taxation; whereas, to sustain the plaintiffs' contention would create discriminatory immunity for a large class of business organizations, thus giving them an unfair advantage over their incorporated competitors.

(7) The conclusion now reached accords with the reasoning and decision of this court in *Malley v. Bowditch* (259 Fed. 809).

In each case the judgment of the district court is reversed and the case is remanded to that court for further proceedings not inconsistent with this opinion; the plaintiff in error recovers costs in this court.

(T. D. 3383, August 9, 1922.)

Estate or inheritance taxes.

Receipt of Liberty bonds, Victory notes, and Treasury notes in payment thereof.

The appended department circular, issued under date of June 30, 1922, with reference to receipt of Treasury notes of the United States in payment of Federal estate and inheritance taxes, is published for the information of internal-revenue officers and others concerned. This circular supplements Department Circular No. 225, dated January 31, 1921 (T. D. 3144).

TREASURY DEPARTMENT, June 30, 1922.

1. The provisions of department circular No. 225, dated January 31, 1921, prescribing regulations governing the receipt of Liberty bonds and Victory notes for federal estate or inheritance taxes, are hereby extended and made applicable to treasury notes of the United States now or hereafter issued under authority of section 18 of the second Liberty bond act, as amended and supplemented, bearing interest at a higher rate than 4 per cent per annum, and any such Treasury notes shall accordingly be receivable by the United States at par and accrued interest in payment of any estate or inheritance taxes imposed by the United States, under or by virtue of any present or future law, upon the same terms and conditions as provided in said department circular No. 225, dated January 31, 1921, with respect to the acceptance of Liberty bonds and Victory notes bearing interest at a higher rate than 4 per cent per annum.

2. The issues of treasury notes at this date outstanding, bearing interest at a higher rate than 4 per cent per annum, are:

Description.	Date of Issue.	Short title.
(a) 5¾ per cent notes, payable June 15, 1924.....	June 15, 1921	Series A-1924.
(b) 5½ per cent notes, payable Sept. 15, 1924.....	Sept. 15, 1921	Series B-1924.
(c) 4¾ per cent notes, payable Mar. 15, 1925.....	Feb. 1, 1922	Series A-1925.
(d) 4¾ per cent notes, payable Mar. 15, 1926.....	Mar. 15, 1922	Series A-1926.
(e) 4¾ per cent notes, payable Dec. 15, 1925.....	June 15, 1922	Series B-1925.

3. For the calculation of accrued interest on the current coupons of Treasury notes tendered in payment of estate or inheritance taxes under this circular, the method outlined in exhibit B to department circular No.

225, dated January 31, 1921, should be followed. Interest tables at the various rates borne by treasury notes may be obtained from the treasury department, division of loans and currency, Washington. The interest tables appropriate for use in connection with the issues of treasury notes at present outstanding are as follows:

Form general 1017, for series A-1924 (interest dates June 15 and December 15).

Form general 1016, for series B-1924 (interest dates March 15 and September 15).

Form L. & C. 369, for series A-1925 prior to September 15, 1922 (interest during this period is on annual 365-day basis).

Form L. & C. 435, for series A-1925 subsequent to September 15, 1922 (interest dates March 15 and September 15).

Form L. & C. 435, for series A-1926 (interest dates March 15 and September 15).

Interest tables or decimals for computing interest as may be required for other or future issues may be obtained from the treasury department, division of loans and currency, Washington, upon request.

(T. D. 3386, Aug. 22, 1922.)

Income tax—Depletion—Oil and gas properties.

Sections 5 and 12 of revenue act of 1916, article 170, Regulations No. 33 (revised), amended.

DEPLETION—OIL AND GAS PROPERTIES.

ART. 170. Sections 5 and 12 of the act of September 8, 1916, as amended by the act of October 3, 1917, authorize:

A reasonable allowance * * * for actual reduction in flow and production * * * provided that when the allowance authorized * * * shall equal the capital originally invested, or in case of purchase made prior to March 1, 1913, the fair market value as of that date, no further allowance shall be made.

The essence of this provision of law is that the owner or operator of this character of properties shall secure through an aggregate of annual depletion deductions the return of the amount of capital actually invested, or an amount not in excess of the fair market value as of March 1, 1913, of the properties owned prior to that date.

For the purpose of determining the amount of capital to be returned through annual deductions, operators may be divided into two classes, (a) operators who own the fee, and (b) operators who own a lease or leases.

In the case of the operating fee owner, the amount returnable through depletion deductions is the fair market value of the property (exclusive of the cost of physical property) as of March 1, 1913, if acquired prior to that date, or the actual cost of the property if acquired on or after that date, plus, in either case, the cost of development (other than the cost of physical property incident to such development) up to the point at which the income from the developed territory equals or exceeds the deductible expenses.

In the case of a lessee, the capital thus to be returned is the fair market value of the lessee's interest as of March 1, 1913, if acquired prior to that date, or the amount paid in cash or its equivalent as a bonus or otherwise by the lessee for the lease if acquired on or after that date, plus, in either case, all expenses incurred in developing the property (exclusive of physical property) prior to the receipt of income therefrom sufficient to meet all deductible expenses, after which time as to both owner and lessee, such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the drilling of wells and further development of the property, may, at the option of the operator, be deducted as an operating expense or charged to capital account. The value of the equities of lessor and lessee shall be computed separately, but when determined as

of the same basic date, shall together never exceed the value at that date of the property in fee simple. By "basic date" is meant March 1, 1913, in case of acquisition prior to that date, or the date of acquisition where it occurred on or after that date.

If, in exercising the option mentioned in the preceding paragraph the individual or corporation charges the expense of drilling wells or 503 further development to capital account, the same, in so far as such expense is represented by physical property, may be taken into account in determining a reasonable allowance for depreciation during each year until the property account thus augmented has been extinguished through annual depreciation deductions, after which no further deduction on this account will be allowed. In the case of a going or producing business, the cost of drilling non-productive wells may be deducted from gross income as an operating expense.

ESTIMATE OF PROBABLE RESOURCES.

In the case of either an owner or lessee it will be required that an estimate, subject to the approval of the commissioner of internal 504 revenue, shall be made of the probable quantity of oil or gas contained in or to be recovered from the territory with respect to which the investment is made. The invested capital (value as of March 1, 1913, or cost, if acquired on or after that date, plus the cost of development, other than cost of physical property, up to the point of expense-paying production), will be divided by the number of units of oil or gas so estimated to be contained in or to be recovered from the territory, and the quotient will be the per unit cost or amount of capital invested in each unit recoverable. This quotient, or per unit cost, when multiplied by the number of units removed from the territory during any one year, will determine the amount which may be allowably deducted from the gross income of that year on account of depletion of assets or as a return of invested capital until the total of such deductions shall equal the capital invested.

Every individual or corporation entitled to a deduction on account of the depletion of the property under operation or for a return of the 505 capital invested with respect to the same shall keep an accurate ledger account, in which, in the case of fee owner, shall be charged the fair market value as of March 1, 1913, or the cost, if acquired on or after that date, of the oil or gas property, plus cost of development as hereinbefore defined, or, in the case of a lessee, the fair market value as of March 1, 1913, or the cost, if acquired on or after that date, of the lessee's interest, plus cost of development. This account shall be credited with the amount claimed and allowed each year as a deduction on account of depletion or as a return of capital, to the end that when the credits to the account equal the debits no further deduction on either account, with respect to this property and the capital invested therein, will be allowed. Or, in lieu of a direct credit to property account, the amount so claimed and allowed as a deduction may be credited to a depletion reserve account.

WHERE RESOURCES ARE UNCERTAIN

If for any reason the quantity of oil or gas in the property can not be determined with any degree of certainty, the depletion deduction 506 will be computed in accordance with the rule set out in T. D. 2447, except that lessees may compute their deduction for return of capital in the same manner as owners in fee; that is, they may extinguish their capital on the basis of the reduction in flow and production as compared with the preceding year, or, in the case of leasehold properties brought in or developed during the year, the depletion deduction may be computed on the basis of the decline in settled flow and production, as evidenced by tests and gauges made at the end of the year as compared with similar tests and gauges made at the time the settled flow was determined.

For the purpose of computing the depletion the territory compre- 507 hended in a given lease will be considered the unit with respect to which the depletion deduction may be claimed and allowed.

During the continuance of the ownership under which the value was fixed or by which the investment was made, there can be no revaluation for the purpose of this deduction if it should be found that the quantity of oil or gas in the property was underestimated at the time the value was fixed or the property was acquired, or at the time the lease contract was entered into or purchased.

This rule will not, however, be so construed as to forbid an operator from redistributing the invested capital over the estimated number of units remaining in the territory under operation if a subsequent increase of invested capital should render this necessary in order to determine the amount of such capital applicable to each unit, provided that when such redistribution is made the total capital invested will be reduced by the amount previously charged off and deducted on account of depletion or as a return of capital.

ADDITIONAL DEPRECIATION FOR MACHINERY, ETC.

Both owners and lessees operating oil or gas properties will, in addition to and separate from the deduction allowable for the depletion or return of capital as hereinbefore provided for, be permitted to deduct a reasonable allowance for depreciation of physical property, such as machinery, tools, equipment, pipes, etc., the amount deductible upon this account to be such an amount, based upon its capitalized value (cost) equitably distributed over its useful life, as will bring it to its true salvage value when no longer useful for the purpose for which such property was acquired.

As to both fee owner and lessee, the capital invested in physical property, upon which the depreciation deduction is computed, should be segregated in the books of account from that invested in the oil or gas territory or in the lease or leases, with respect to which the deduction for depletion or return of capital is claimed, and credits for depreciation may be made in the same manner as hereinbefore provided for depletion.

STATEMENT REQUIRED.

To each return made by an individual or corporation owning, or holding under lease, oil or gas properties there should be attached a statement showing—

(1) (a) The fair market value of the property or interest therein (exclusive of machinery, equipment, etc.) as of March 1, 1913, if acquired prior to that date, or (b) the actual cost thereof if acquired on or after that date.

(2) How the fair market value as of March 1, 1913, was ascertained.

(3) The estimated quantity of oil or gas in the sand at the time the value or cost was determined.

(4) Amount of capital applicable to each unit.

(5) The quantity of oil or gas produced during the year for which the return is made.

(6) Any other data which would be helpful in determining the reasonableness of the depletion deduction.

JOSEPH W. FIRTH

Joseph W. Firth, member of the American Institute of Accountants, died September 9, 1922. Mr. Firth was a certified public accountant of New York and had been in practice for many years. He was a partner in the firm of Cornwall & Firth.

Students' Department

EDITED BY H. A. FINNEY

The following problems have been submitted to this department by readers of THE JOURNAL OF ACCOUNTANCY, with requests for solutions:

A, B and C are incorporated companies, intimately related and engaged in similar business. In the early part of the year 1919 company A purchased in the open market 1,000 shares of the common stock of company B, having a par value of \$100 a share, for which it paid \$150 a share, and on August 10, 1919, it purchased preferred stock of company B for which it paid \$50,000, that being the par value of the stock then acquired.

On January 2, 1920, company A acquired 1,000 shares of the common stock of company B, par value \$100 a share, for which it gave in exchange 2,000 shares of its own common stock, having a par value of \$100 a share. The rights to the dividend on the stock so acquired, payable January 10, 1920, were transferred to company A.

BALANCE-SHEET—COMPANY A—DECEMBER 31, 1920

Capital stock, common.....		\$700,000.00
Land	\$ 40,000.00	
Buildings	75,000.00	
Machinery	100,000.00	
Investments—Common stock—B	\$350,000.00	
Preferred stock—B.....	50,000.00	
		400,000.00
Cash	49,500.00	
Inventories	88,000.00	
Accounts receivable	85,000.00	
Accounts payable		51,500.00
Notes receivable, company B.....	\$10,000.00	
Notes discounted	10,000.00	
Accrued wages		8,000.00
Accrued taxes		6,000.00
Deferred charges	1,500.00	
Dividends payable		35,000.00
Dividends receivable	31,750.00	
Surplus		70,250.00
	\$870,750.00	\$870,750.00

The following is an analysis of the surplus account:

Jan. 1, 1920	Balance	\$ 10,000.00	
Jan. 2, 1920	Dividend preferred stock Co. B.....	1,750.00	
Jan. 10, 1920	Dividend common stock Co. B.....	20,000.00	
July 3, 1920	Dividend preferred stock Co. B.....	1,750.00	
July 10, 1920	Dividend common stock Co. B.....	30,000.00	
Dec. 31, 1920	Dividend preferred stock Co. B.....	1,750.00	
Dec. 31, 1920	Dividend common stock Co. B.....	30,000.00	
Dec. 31, 1920	Net profits for year.....	45,000.00	
			\$140,250.00
June 30, 1920	Dividend declared, 5%.....	35,000.00	
Dec. 31, 1920	Dividend declared, 5%.....	35,000.00	
			70,000.00
Dec. 31, 1920	Balance		\$ 70,250.00

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Company B owns 900 shares of the common stock of company C, par value \$100 a share, for which it paid \$125 a share. This stock was acquired on January 1, 1920, without right to the dividend declared on December 31, 1919, and payable on January 10, 1920. The capital stock of company C outstanding on January 1, 1920, amounted to \$100,000.

BALANCE-SHEET—COMPANY B—DECEMBER 31, 1920

Capital stock, common.....		\$200,000.00
Capital stock, preferred 7%.....		100,000.00
Land	\$ 25,000.00	
Buildings	50,000.00	
Machinery	75,000.00	
Cash	46,100.00	
Inventories	47,500.00	
Accounts receivable	66,500.00	
Investment, 900 shares C stock.....	112,500.00	
Dividends receivable	5,400.00	
Deferred charges	800.00	
Accounts payable		36,500.00
Notes payable (to company A).....		10,000.00
Accrued wages		3,000.00
Accrued taxes		2,000.00
Dividends payable		33,500.00
Surplus		43,800.00
	<u>\$428,800.00</u>	<u>\$428,800.00</u>

Analysis of surplus account shows the following:

Jan. 1, 1920	Balance	\$65,000.00	
June 30, 1920	Dividend company C, 6%.....	5,400.00	
Dec. 31, 1920	Dividend company C, 6%.....	5,400.00	
Dec. 31, 1920	Net profits for year.....	35,000.00	
		<u>\$110,800.00</u>	
June 30, 1920	Dividend common, 15%.....	\$30,000.00	
June 30, 1920	Dividend preferred, 3½%.....	3,500.00	
Dec. 31, 1920	Dividend preferred, 3½%.....	3,500.00	
Dec. 31, 1920	Dividend common, 15%	30,000.00	
		<u>67,000.00</u>	
Dec. 31, 1920	Balance		\$43,800.00

NOTE: Dividends on the preferred stock of company B are payable on January 1 and July 1, and on the common stock, January 10 and July 10.

BALANCE-SHEET—COMPANY C—DECEMBER 31, 1920

Capital stock		\$100,000
Land	\$ 10,000.00	
Buildings	15,000.00	
Machinery	20,000.00	
Cash	28,000.00	
Accounts receivable	46,500.00	
Inventories	34,000.00	
Deferred charges	500.00	
Accounts payable		32,500.00
Dividends payable		6,000.00
Accrued wages		1,500.00
Accrued taxes		1,000.00
Surplus		13,000.00
	<u>\$154,000.00</u>	<u>\$154,000.00</u>

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Analysis of surplus account shows the following:

Jan. 1, 1920	Balance	\$ 15,000.00	
Dec. 31, 1920	Net profits for year.....	10,000.00	25,000.00
June 30, 1920	Dividend declared, 6%.....	6,000.00	
Dec. 31, 1920	Dividend declared, 6%.....	6,000.00	12,000.00
Dec. 31, 1920	Balance	\$13,000.00	

NOTE: Dividends are payable January 10 and July 10.

From the data given you are required to submit a consolidated balance-sheet, showing the minority interests.

Solution

There are two distinct methods for making eliminations from stock investment accounts to determine the goodwill to appear in a consolidated balance-sheet.

If the holding company carries the investment in the subsidiary at cost and takes up dividends received as a credit to surplus, the book value of the subsidiary stock ownings at the date of acquisition of the stock should be eliminated. This elimination is made, of course, from the investment account on the asset side and from the subsidiary's capital stock and surplus accounts on the liability side.

If the holding company has taken up subsidiary profits since acquisition by a debit to the investment account and a credit to surplus and has taken up dividends from the subsidiary by a debit to cash or dividends receivable and a credit to the investment account, then the eliminations should be based on the book value at the date of the consolidated balance-sheet.

The second method is much the easier to use when, as in this case, stock purchases are made at different dates, and particularly when the major holding company (company A in this case) owns stock in a minor holding company (company B) and thus indirectly controls a minor subsidiary (company C).

We are therefore faced by this situation: Companies A and B have carried the investments at cost and have credited dividends to surplus; but the solution of the problem would be simplified if they had charged the investment accounts and credited surplus with their shares of subsidiary earnings and had credited the investment accounts with subsidiary dividends. The situation may be met by setting up a statement for each holding company, showing what the investment account and surplus account balances would have been if subsidiary profits had been credited to surplus and if subsidiary dividends had been credited to the investment accounts. Adjustments can then be made changing the investment and surplus balances to these revised figures, and eliminations can then be made on the basis of present book values.

Statements for company B and company A appear on pages 300, 301, 302 and 303.

Turning to company A, we are faced by two difficulties. First, the exact date of the acquisition of the stock of B "early in 1919" is not known, and company B's surplus at the date of acquisition is also unknown. This is a very serious flaw in a problem which is otherwise excellent, although in my opinion it is unreasonably difficult for a C. P. A. examination. It is not necessary to know the exact date when company A made its first acquisition of B's stock, but it is absolutely necessary to know B's surplus at that date. Without this information it is simply impossible to solve the problem; as impossible as it would be to prepare a profit-and-loss statement without knowing the final inventory. An assumption is necessary, and I shall assume that the dividend of \$20,000 received on January 10, 1920, represented the profits of company

EXHIBIT A
COMPANY B

STATEMENT TAKING UP SUBSIDIARY PROFITS AS CREDITS TO SURPLUS AND DIVIDENDS AS CREDITS TO THE INVESTMENT ACCOUNT		
	<i>Investment in Co. C</i>	<i>Surplus</i>
Jan. 1, 1920—Surplus.....		\$ 65,000.00
Jan. 1, 1920—Investment in C stock, 90%.....	\$112,500.00	
Profits, 1920:		
From own operations.....		35,000.00
90% of company C's \$10,000 profits.....	9,000.00	9,000.00
Total profits.....		<u>\$ 44,000.00</u>
Dividends from company C:		
June 30, 1920 (debit cash).....	\$ 5,400.00	
Dec. 31, 1920 (debit dividends receivable).....	5,400.00	
Dividends declared:		
June 30, 1920:		
Common.....		\$30,000.00
Preferred.....		3,500.00
Dec. 31, 1920:		
Common.....		30,000.00
Preferred.....		3,500.00
Adjusted balances.....	110,700.00	42,000.00
	<u>\$121,500.00</u>	<u>\$109,000.00</u>
Adjusted balances—down.....	110,700.00	42,000.00
Balances—per balance sheet.....	112,500.00	43,800.00
Adjustments (see main working papers).....	1,800.00 Credit	1,800.00 Dr.

EXHIBIT B
COMPANY A

STATEMENT TAKING UP SUBSIDIARY PROFITS AS CREDITS TO SURPLUS AND DIVIDENDS AS CREDITS TO THE INVESTMENT ACCOUNT

	Investment in B Common	Investment in B Preferred	Surplus
"Early in 1919": Investment in B common (50%).....	\$150,000		
Aug. 10, 1919: Investment in B preferred (50%).....		\$50,000	
Jan. 1, 1920: Surplus			\$10,000
Jan. 2, 1920: Investment in B common (50%).....	190,000		1,750*
Jan. 2, 1920: Dividend on preferred			10,000**
Jan. 10, 1920: Dividend on common			
On stock acquired "early in 1919"; on stock acquired Jan. 2, 1920, credit dividends receivable.....			
July 3, 1920: Dividend on preferred			1,750
July 10, 1920: Dividend on common	\$30,000		
Dec. 31, 1920: Dividend on preferred (debit dividends re- ceivable)			1,750
Dec. 31, 1920: Dividend on common (debit dividends re- ceivable)	30,000		
Dec. 31, 1920: Profits:			
From own operations			
From ownership of B stock:			
Total profits (Ex. A).....			45,000
Less pref. dividends.....			
7,000			
Earnings for common	37,000		37,000
June 30, 1920: Dividends		\$35,000	
Dec. 31, 1920: Dividends		35,000	
Adjusted balances	317,000	\$50,000	37,250
	<u>\$377,000</u>	<u>\$50,000</u>	<u>\$107,250</u>
Adjusted balances—down	317,000	50,000	37,250
Balances—per balance sheet	<u>350,000</u>	<u>50,000</u>	<u>70,250</u>
Adjustments	33,000 Credit	0	33,000 Debit

*This \$1,750.00 is a dividend for six months. Company A did not own the stock for the full six months period, but it paid nothing for accrued dividends. Hence the entire dividend is treated as income.

**Credited to surplus in accordance with the assumption (probably false, but some assumption is necessary in the absence of information) that the dividend received was equal to the profit earned since "early in 1919."

COMPANY A AND SUBSIDIARIES B AND C
CONSOLIDATED WORKING PAPERS—DECEMBER 31, 1920

Assets—	Co. A	Co. B	Co. C	Adjustments Dr.	Elimina- tions	C. B. S.
Land	\$40,000	\$25,000	\$10,000			\$75,000
Buildings	75,000	50,000	15,000			140,000
Machinery	100,000	75,000	20,000			195,000
Investment in common stock of Co. B—100%.....	350,000					
Adjustment—as per exhibit B.....				\$33,000 a		
Eliminate present book value:						
Capital stock					\$200,000 A	
Surplus—as adjusted					42,000 B	
Goodwill						75,000 G
Investment in preferred stock of Co. B—50%.....	50,000					
Eliminate book value—par					50,000 C	
Cash	49,500	46,100	28,000			123,600
Inventories	88,000	47,500	34,000			169,500
Accounts receivable	85,000	66,500	46,500			198,000
Notes receivable—Co. B	10,000				10,000 F	
Deferred charges	1,500	800	500			2,800
Dividends receivable from Co. B:						
Common	30,000				30,000 G	
Preferred	1,750				1,750 H	
Investment in stock of Co. C—90%.....		112,500				
Adjustment as per exhibit A.....				1,800 b		
Eliminate present book value:						
Par					90,000 D	
Surplus—90% of \$13,000					11,700 E	9,000 G
Goodwill					5,400 I	
Dividends receivable from Co. C						
	\$880,750	\$428,800	\$154,000	\$34,800	\$440,850	\$987,900

Students' Department

WORKING PAPERS—Continued

Liabilities—							
Adjustment column total forward							
Capital stock:							
Co. A	\$700,000						
Co. B—common		\$200,000				\$200,000 A	50,000 M
Co. B—preferred		100,000				50,000 C	10,000 M
Co. C			\$100,000			90,000 D	120,500
Accounts payable	51,500	36,500	32,500				10,000
Notes receivable—Co. B—discounted	10,000						12,500
Accrued wages	8,000	3,000	1,500				9,000
Accrued taxes	6,000	2,000	1,000				35,000
Dividends payable							
Notes payable—Co. A	35,000	10,000				10,000 F	
Dividends payable:							
Common		30,000				30,000 G	1,750 M
Preferred		3,500				1,750 H	600 M
Dividends payable			6,000			5,400 I	
Surplus:							
Co. A	70,250				\$33,000 a		37,250
Adjustment—exhibit B							
Adjusted balance							
Co. B		43,800			1,800 b		
Adjustment—exhibit A						42,000 B	
Eliminate present adjusted surplus							
Co. C			13,000			11,700 E	1,300 M
Eliminate Co. B's 90%							
Minority 10%							
	\$880,750	\$428,800	\$154,000	\$34,000	\$34,800	\$440,850	\$987,900

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B from "early in 1919" to the end of 1919. Of this amount, only \$10,000 is income to company A, for payment was made for the right to the dividend on 1,000 shares of B stock purchased on January 2, 1920. In other words, when the A company paid \$200,000 of its own stock for the stock of B, it should have recorded the transaction thus:

Investment in stock of company B.....	\$190,000.00
Dividends receivable	10,000.00
Capital stock	\$200,000.00

When the dividend was received on January 10, dividends receivable should have been credited with \$10,000.00; surplus should have been credited with \$10,000.00; and cash should have been debited for the total. It is to be remembered that surplus is credited because we are assuming that the dividend is exactly equal to B's profit since "early in 1919."

The second difficulty arises from the necessity of determining the rights of the preferred stockholders in B's surplus. The law provides that preferred stock is participating when not definitely stated to be non-participating, but the fact that 15% dividends have been paid on common stock and 3½% dividends have been paid on preferred stock gives adequate information that the preferred stock is non-participating and that its book value is par.

COMPANY A AND SUBSIDIARIES B AND C CONSOLIDATED BALANCE-SHEET DECEMBER 31, 1920

Assets

Fixed assets:

Goodwill	\$ 84,000.00
Land	75,000.00
Buildings	140,000.00
Machinery	195,000.00
	\$494,000.00

Current assets:

Inventories	\$169,500.00
Accounts receivable	198,000.00
Cash	123,600.00
	491,100.00

Deferred charges:

Total all items	2,800.00
	\$987,900.00

Liabilities

Current liabilities:

Accounts payable	\$120,500.00
Notes payable	10,000.00
Accrued wages	12,500.00
Accrued taxes	9,000.00
Dividends payable—company A.....	35,000.00
	\$187,000.00

Minority interests:

	Co. B	Co. C
Preferred stock	\$50,000.00	
Common stock		\$10,000.00
Surplus		1,300.00
Dividends payable	1,750.00	600.00
	\$51,750.00	\$11,900.00
Total		63,650.00

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Capital:

Capital stock	\$700,000.00	
Surplus	37,250.00	
		737,250.00
		\$987,900.00

Problem:

A and B are partners engaged in the business of manufacturing. Desiring additional capital so as to extend their operations, they make overtures to C and submit the following balance-sheet for his consideration:

BALANCE-SHEET—A AND B—JANUARY 1, 1918

Land	\$ 10,000.00	
Buildings	25,000.00	
Machinery	65,000.00	
Inventory: Raw material	\$ 40,000.00	
Finished goods	6,000.00	
Goods in process	3,000.00	
	49,000.00	
Cash	6,000.00	
Accounts receivable	15,000.00	
Deferred	1,000.00	
Accrued taxes		\$2,000.00
Accrued wages		14,000.00
Accounts payable		20,000.00
Notes payable		5,000.00
A's capital		70,000.00
B's capital		60,000.00
		\$171,000.00
		\$171,000.00

Examination discloses that buildings and machinery had not been depreciated and that the inventory of raw materials was overstated. It was finally agreed that the following deductions be made from the values shown on the balance-sheet:

Deduct: Buildings	\$ 5,000.00
Machinery	15,000.00
Inventory—raw materials	4,000.00
Accounts receivable	1,000.00
	\$25,000.00

The deductions for depreciation are to be set up on the books as a reserve for depreciation; the deduction for raw materials is to be charged off and the inventory accordingly corrected; accounts receivable is to be adjusted by charging off \$400.00 for uncollectible accounts, and \$600.00 is to be set up as a reserve for bad debts.

These adjustments having been made, C agrees to contribute \$60,000.00 in cash to the partnership in consideration for a third interest in the business, which offer was accepted by A and B as of January 1, 1919, and C made payment accordingly.

The capital of the partnership after the admission of C is to equal the net assets after making the adjustments agreed on, plus the cash contribution of C.

Prior to the entrance of C into partnership, the profits and losses were divisible between A and B in the proportions of 60% and 40% respectively.

The net profits for the year ended December 31, 1919, were \$25,000.

From the foregoing data you are required to show (a) the adjustment of the respective capital accounts after settlement with C at the beginning of the year; (b) revised percentages of profits for the year 1919, and (c) division of profits for the year 1919.

Solution:

The problem does not ask for a revised balance-sheet after the admission of C. Therefore it is not necessary to do more than show the effect upon the capitals of A and B resulting from the stated deductions.

	A	B	Together
Capitals before adjustments.....	\$70,000.00	\$60,000.00	\$130,000.00
Deduct adjustments in P. and L. ratio....	15,000.00	10,000.00	25,000.00
Balances before admission of C.....	\$55,000.00	\$50,000.00	\$105,000.00

The problem states that C is to obtain a one-third interest in the business for a payment of \$60,000.00, and that the capital of the partnership after the admission of C is to equal the net assets after making the adjustments agreed on, plus the cash contribution of C. It is therefore necessary to determine whether C's \$60,000.00 is exactly one-third of this total or whether a transfer must be made from A's and B's accounts to C's, or vice versa.

Total net assets before C's admission.....	\$105,000.00
Add C's contribution.....	60,000.00
Total	\$165,000.00
One-third thereof	\$ 55,000.00

This shows that while C pays in \$60,000.00 he is to be credited with only \$55,000.00. In other words, \$5,000.00 is to be transferred from his capital account to the capital accounts of A and B. This transfer is made in the profit and loss ratio, as follows:

Capitals before transfer.....	\$55,000.00	\$50,000.00	\$60,000.00
Transfer	3,000.00	2,000.00	5,000.00
Final balance	\$58,000.00	\$52,000.00	\$55,000.00

The admission of C dissolves the old partnership between A and B and abrogates the contract between them as to the division of profits. Unless a new agreement is specifically stated, the assumption is that the profits in the new partnership will be divided in equal thirds of \$8,333.33 to each.

If the former 60% and 40% ratio is to govern the distribution of the profits remaining for A and B after allowing C one-third of the profits, the problem should say so. Otherwise the \$8,333.33 division is correct. If the old ratio between A and B does govern the division of their two-thirds, the distribution would be made as follows:

Partner	Ratio	Profits
A	60% of 66 2/3% or 40%	\$10,000.00
B	40% of 66 2/3% or 26 2/3%	6,666.67
C	33 1/3%	8,333.33
Total	100%	\$25,000.00

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Problem:

On January 1, 1921, the directors of Simpson Company, Inc., decided to cease operations, liquidate the business and dissolve the corporation as soon as possible. The balance-sheet, as at December 31, 1920, was as follows:

SIMPSON COMPANY, INC.			
BALANCE-SHEET AS OF DECEMBER 31, 1920			
<i>Assets</i>		<i>Liabilities</i>	
Assets	\$ 10,000.00	Accounts payable	\$ 96,500.00
Accounts receivable	45,000.00	Dividends payable	3,500.00
Inventories	60,000.00	Accrued interest on bonds	1,750.00
Machinery and equipment	50,000.00	First mortgage gold bonds	100,000.00
Plant	200,000.00	Rental paid in advance.....	350.00
Goodwill	105,000.00	Reserve for bad debts.....	1,900.00
Deferred charges.....	2,500.00	Reserve for department	
Unamortized discount on		machinery & equipment	10,000.00
bonds	3,333.33	Reserve for department	
Bond sinking-fund cash....	82,000.00	plant	5,000.00
		Reserve for contingencies	10,000.00
		Reserve for sinking fund	82,000.00
		Preferred stock (1,000	
		shares)	100,000.00
		Common stock (1,050	
		shares)	105,000.00
		Surplus	41,833.33
	\$557,833.33		\$557,833.33

The preferred stock certificates contain a provision that preferred stock is to receive semi-annual dividends at the rate of 7% per annum, payable January 1st and July 1st, the dividends to be cumulative if not paid. On dissolution, the preferred stock is to be retired at 110, plus dividends accrued from the date of the last dividend declaration, December 31, 1920, to the date set by the directors in the notice to stockholders to surrender their preferred stock for cancellation. The holders of common stock are to receive, on dissolution, all of the remaining net assets.

On March 3, 1921, the directors, acting as liquidators, reported the following transactions in connection with winding up the company's affairs:

Accounts receivable had realized 80% of their face value.

All accounts payable and dividends payable had been settled.

All merchandise had been disposed of for \$40,000.00.

Machinery and equipment had been sold for \$22,000.00

The sinking-fund trustee had been paid sufficient additional cash to buy in all outstanding bonds at 98½, plus the interest accrued to December 31, 1920. Any additional accrual is to be disregarded.

The sinking-fund trustee had redeemed all bonds in accordance with the preceding paragraph and had been discharged. Any possible trustee's expenses and commissions are to be disregarded.

The bond liability having been liquidated, the plant was sold for \$180,000.00. The purchaser of the plant would not assume the property subject to the lease held by a tenant who occupied the top floor, whose prepaid rental was reflected in the balance-sheet as at December 31, 1920. In order to consummate the sale of the plant, it was necessary to effect a cancellation of the lease, which was done by payment to the tenant of \$3,500.00 and the refund to him of the advance payment mentioned.

Miscellaneous expenses of realization and liquidation were \$4,000.00.

On April 9, 1921, the directors notified all stockholders to turn their stock certificates in for cancellation as of date April 19, 1921. On the latter date, all certificates having been received from the stockholders, the assets on hand were distributed pro-rata to each class of stockholders, and the stock certificates were canceled.

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From the foregoing facts prepare:

- (a) Realization and liquidation statement.
- (b) Statement showing realized value per share of stock.

THE SIMPSON COMPANY, INC. REALIZATION AND LIQUIDATION ACCOUNT December 31, 1920, to April 19, 1921. (Left side)

Assets to be realized:

Accounts receivable	\$ 45,000.00	
Less reserve for bad debts.....	1,900.00	
		\$ 43,100.00
Inventories		60,000.00
Machinery and equipment.....	\$ 50,000.00	
Less reserve for depreciation.....	10,000.00	40,000.00
Plant	200,000.00	
Less reserve for derpeciation.....	5,000.00	195,000.00
Goodwill		105,000.00
Deferred charges		2,500.00
		<u>\$445,600.00</u>

Liabilities liquidated:

Accounts payable	\$ 96,500.00	
Dividends payable.....	3,500.00	
Bond payable—\$100,000.00 par retired at 98½....	98,500.00	
Accrued interest on bonds.....	1,750.00	
Rental paid in advance.....	350.00	
		<u>200,600.00</u>

Supplementary Charges:

Premium for cancelation of lease.....	\$ 3,500.00	
Expenses of realization and liquidation.....	4,000.00	
		<u>7,500.00</u>
		<u>\$653,700.00</u>

THE SIMPSON COMPANY, INC. REALIZATION AND LIQUIDATION ACCOUNT December 31, 1920, to April 19, 1921. (Right side)

Liabilities to be liquidated:

Accounts payable	\$ 96,500.00	
Dividends payable	3,500.00	
Accrued interest on bonds.....	1,750.00	
First mortgage gold bonds.....	100,000.00	
Rental paid in advance.....	350.00	
		<u>\$202,100.00</u>

Assets realized:

Accounts receivable	\$ 36,000.00	
Inventories	40,000.00	
Machinery and equipment.....	22,000.00	
Plant	180,000.00	
		<u>278,000.00</u>
Loss on realization.....		<u>173,600.00</u>
		<u>\$653 700.00</u>

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THE SIMPSON COMPANY, INC. REALIZATION PROFIT-AND-LOSS ACCOUNT December 31, 1920, to April 19, 1921.

Loss on realization of		
Accounts receivable	\$ 7,100.00	
Inventories	20,000.00	
Machinery and equipment	18,000.00	
Plant	15,000.00	
Goodwill	105,000.00	
Deferred charges	2,500.00	
		\$167,600.00
Premium to cancel lease	3,500.00	
Expenses of realization and liquidation	4,000.00	
Total		\$175,100.00
Deduct discount on redemption of bonds		1,500.00
Net loss on realization		\$173,600.00

THE SIMPSON COMPANY, INC. STATEMENT OF CASH December 31, 1920, to April 19, 1921.

Cash balance, December 31, 1920	\$ 10,000.00	Accounts payable	\$ 96,500.00
Sinking-fund cash, December 31	82,000.00	Dividends payable	3,500.00
Accounts receivable	36,000.00	Bonds payable	98,500.00
Inventories	40,000.00	Accrued interest on bonds	1,750.00
Machinery and equipment	22,000.00	Rental refund	350.00
Plant	180,000.00	Cancellation of lease	3,500.00
		Expenses	4,000.00
	\$370,000.00	Balance for stockholders	161,900.00
Balance down	\$161,900.00		
		Payment to preferred:	
		Par	\$100,000.00
		Premium	10,000.00
		Dividend	2,090.00
			\$112,090.00
		Payment to common	49,810.00
	\$161,900.00		\$161,900.00

THE SIMPSON COMPANY, INC. STATEMENT OF CAPITAL

Capital—December 31, 1920:	
Preferred stock	\$100,000.00
Common stock	105,000.00
Surplus	\$ 41,833.33
Less discount on bonds	3,333.33
Reserve for contingencies	38,500.00
Reserve for sinking fund	10,000.00
	\$335,500.00
Deduct loss on realization	173,600.00
Capital—April 19, 1921	\$161,900.00

Liquidating dividends:

To preferred stockholders:

Par	\$100,000.00	
Premium	10,000.00	
Dividend: $109/365$ of \$7,000.00.....	2,090.00	
		112,090.00

To common stockholders..... \$49,810.00

The payment of the dividend for the fractional period is an absolute requirement, based on an agreement between the common stockholders and preferred stockholders. It is not conditional upon the existence of a surplus.

Realized value per share:

Preferred: $\$112,090.00 \div 1,000 = \$112.09$

Common: $49,810.00 \div 1,050 = 47.44$

ADIN S. HUBBARD

Adin S. Hubbard, member of the American Institute of Accountants, certified public accountant of Rhode Island, died August 18, 1922. To everyone in New England acquainted with accountancy Mr. Hubbard was well known. He was a regular attendant at meetings of the American Institute of Accountants. He was a member of the Rhode Island Society of Certified Public Accountants and was also a member of the state board of accountancy.

Allen R. Smart, Edward E. Gore, David A. Houston and William B. Boulter announce the formation of the firm of Smart, Gore & Co., with offices at 111 West Monroe street, Chicago, Illinois.

Alfred N. Maas and Philip Sohmer announce the formation of a partnership under the name of Maas & Sohmer, with offices at 1170 Broadway, New York.

Washington Society of Certified Public Accountants

At the annual meeting of the Washington Society of Certified Public Accountants held August 26, 1922, William McAdam, J. P. Robertson and James M. McConahey were elected directors for a term of two years. They, with the holdovers, A. S. Hansen and E. P. Jarvis, will constitute the board of directors for the next year.

A. S. Hansen was re-elected president, J. P. Robertson re-elected vice-president, James M. McConahey elected secretary-treasurer, and W. O. Atwood, auditor.

The by-laws were amended to provide for local chapters in addition to the state society. A local chapter was immediately formed in Seattle and the officers and directors of the state society were elected to the same positions in the chapter. Chapters are also now being formed in Spokane and Tacoma. The reports of the officers showed the most successful year in the history of the society.

Terminology Department

CONDUCTED BY THE SPECIAL COMMITTEE ON ACCOUNTING TERMINOLOGY
OF THE AMERICAN INSTITUTE OF ACCOUNTANTS

The committee on terminology presents in this issue of THE JOURNAL OF ACCOUNTANCY definitions of:

Accrue
Allowance
Provision
Requirement
Reserve
Surplus

Accrue:

This word conveys the following meanings:

- (a) To accumulate, as an accrual of interest.
- (b) To come as a natural result or increment, as by growth.
- (c) To come into existence, as a right or the like.
- (d) To arise, as an addition, accession or advantage.
- (e) To become vested (legal usage), indicating a present and enforceable right or demand.
- (f) To increase (rare usage.)

The meaning most commonly met in accounting practice is that of accumulation [(a) above] based upon lapse of time, e.g., in the case of interest it signifies an accumulation to a stated date of an item receivable or payable at a later date but covering a period commencing prior to the stated date.

Allowance:

This word conveys the idea of that which is approved, permitted, awarded, conceded, yielded or assigned.

As used in accounting it indicates—

1. A recognition of modifying circumstances or a margin for deviations from standard; specifically
 - (a) A deduction from the purchase or selling price of commodities on account of short weight, inferior quality, damaged goods, delayed delivery, breach of contract, etc. Such deductions should be made directly from the accounts which they affect.
 - (b) A deduction from the amount charged for personal services rendered, for work performed or for service furnished (heat, light, telephone, transportation, etc.), either receivable or payable, on account of dissatisfaction, breach of contract, etc.
 - (c) A deduction of a lump sum from an amount receivable or payable for prompt payment, as distinct from a percentage discount.

The above allowances are deductible from the accounts containing the items upon which the allowances are made, whether such accounts be nominal or real.

2. An amount granted for a specific purpose, e.g., an allowance for office rent; an allowance in lieu of actual expenses.

In law the word is used to denote an extra sum awarded, in addition to regular costs, to the successful party in a difficult case.

In minting the word is used to denote a permissible deviation in the fineness and weight of coins, owing to the difficulty in securing exact conformity to standard prescribed by law.

Note: The word "allowance" is occasionally used synonymously with "reserve," e.g., allowance for depreciation or allowance for bad debts, but this usage should be discouraged.

Provision:

This word is used as a substitute for "reserve" but should only provide:

- (a) For *liabilities known to exist*, the exact amount of which will not be known until a later date, e.g., income taxes, overlapping accounts payable (bills or invoices not received or not audited and not entered on books), dividends declared but the amount of which is not known because of outstanding convertibles.
- (b) For *disputed liabilities* arising out of or due to past operations or activities, e.g., judgments payable on appeal, additional income taxes levied but disputed and under review by the taxing authorities or being adjudicated in the courts. Obligations contingent upon the future action or non-action of other parties should be reserved for and not provided for, e.g., reserve for notes discounted.

In its legal sense the word (usually in the plural) means a distinct stipulation, the part of an agreement, arrangement or rule referring to one specific thing, e.g., the provisions of a bill.

Requirement:

This word conveys the idea of something that is needed by virtue of the attendant circumstances or the nature of things; a necessity or requisite; something that must be provided for in a financial way.

In its legal sense, the word indicates a condition that must be met or a rule that must be observed.

Reserve:

The correct use of this word, as applied to an account, will be facilitated by reference to its derivation, *re*, back, and *servare*, to keep, i.e., a keeping back or withholding.

A reserve account indicates a segregation of and withholding for a specific purpose of past or current profits, revenue or income from any source. It is invariably a credit account and may be provided to cover:

1. An estimated loss in value of physical property which has theoretically occurred in the past or is due to or arises from past operations or activities; e.g., reserve for wear and tear.
2. An estimated or actual loss in value of choses in action, e.g., reserve for bad and doubtful debts, reserve for depreciation or

- fluctuation of securities (to cover repudiation, bankruptcy, insolvency or merely a temporary fluctuation.)
3. A discounting or proration of future estimated or actual loss of exclusive use or possession of intangible capital such as patents, copyrights, franchises, leaseholds, rights of way, water rights or special terminable privileges or rights of any kind which have been capitalized. A *reserve for amortization* should be used in this case where lapse of time is the governing factor.
 4. An estimated loss in value of physical property which may (problematical as to occurrence) or will (problematical as to extent) occur in the future, e. g., a self-insurance reserve to cover loss by fire, accident, casualty or action of the elements.
 5. An estimated future expenditure for compensation to employees or other necessitated by reason of the foregoing contingencies, e. g., reserve for workmen's compensation or reserve for accident liability.
 6. An estimated future expenditure or loss occasioned by guaranties or endorsements, contingent upon the future action or non-action of other parties to the transactions; e. g., a reserve for notes discounted or a reserve for accommodation endorsements; or an estimated future expenditure or loss contingent upon breach of warranty, or upon non-fulfilment of contractual conditions, e. g., reserve for tire mileage.
 7. An estimated future expenditure for capital outlay, the reserve being created to conserve the available cash balance by reducing the amount of unappropriated surplus, e. g., reserve for capital additions. From the standpoint of accounting terminology, this is an unfortunate use of the word "reserve." "Appropriated surplus" is a preferable designation.
 8. An actual or estimated loss in value of tangible property of any kind which has occurred in the past, partly or wholly recoverable by insurance and in process of amicable adjustment with or disputed by insurers; e. g., reserve for fire loss.

A loss of possession of tangible property of any kind due to burglary, larceny, embezzlement or defalcation, not covered by insurance, should, upon discovery, be written off to an appropriate nominal account. A reserve should not be created for such loss. The property value should be reinstated in the assets and the nominal account should be credited, if and when recovery ensues. If, however, the exact amount of the loss may not be determined for some time, an appropriate reserve account may be set up in the books as a temporary expedient, subject to clearance and adjustment when the facts are known.

A reserve account which is created to cover losses in the past or an amortization reserve for future loss of use or possession is, in effect, abatement of the corresponding assets, whereas reserve accounts created to cover losses and attendant expenses which may or will occur in the future or to cover future capital outlays or other future expenditures are

mere segregations of surplus and as such are part of the true net worth of a business.

Some eminent accountants have used the word reserve as descriptive of a "reserve fund," but this practice, which is an excellent example of the confusion existing in accounting terminology, is falling into disuse.

Reserve is also used in a descriptive sense to denote something stored up for future use or in excess of current needs, e. g., a reserve stock of materials, or to denote something set apart for a particular purpose, e. g., a reserve of land, but in neither case is it customary to give effect to the designation in the books of account.

In still another sense reserve is used to denote the minimum ratio of cash and choses in action to the amount due depositors which banks are required by law to maintain at all times.

Note: A reserve for loss on containers or on other property delivered to vendees and to be returned by them has fallen into disuse in most industries as such loss is now usually obviated by a tentative charge or actual deposit.

Surplus:

This word is a contraction of two Latin words, super, meaning above, and plus, meaning more: an overplus; something left over after certain requirements are fulfilled.

As applied to corporations or similar forms of legal entity organized and conducted for profit, surplus, in its broadest significance, measures the excess of assets over liabilities and capital. When used without qualification, or designated as "unappropriated," "free" and the like, and in absence of legal restriction, it indicates the maximum amount of undistributed profits which, if available in liquid form, may be distributed to stockholders or other legal participants in the discretion of directors or others charged with such distribution, as stated below. When designated as "manufacturing," "operating," and the like, it indicates the accrued profits pertaining to a certain phase of a business. When designated as "appropriated," "reserved," and the like, it indicates the amount of undistributed profits withheld for some specific purpose.

Surplus (a) may be accumulated through the normal operations of a business, (b) it may be paid in upon incorporation or as part of later financing, (c) it may result from a reappraisal of assets, reflecting thereby either a correction or adjustment of former account classification or an unearned increment, (d) it may be acquired through the purchase of a company's own stock or obligations, or in other ways. However, surplus is surplus by whatever legal means acquired and is distributable as such, subject to the facts, legal aspects and moral restrictions applicable to each case.

In some corporations "profit and loss," "undivided profits," or "loss and gain" is used in place of "surplus," and in other cases two accounts are kept, the former to reflect the results of current operations, while "surplus" is the account to which the former is closed at the end of a fiscal period.

Terminology Department

In partnership accounts, the account corresponding to "surplus" is usually designated as "profit and loss" or as "undistributed profits" and is distributable in accordance with the partnership agreement, whether written or oral.

The surplus of a government (federal, state or city) or of a corporation or other form of legal entity not organized or conducted for profit (e. g., an educational, eleemosynary or religious organization) indicates the excess of available resources over obligations and commitments, which may be applied to or used for future activities.

Communications should be addressed to any one of the undersigned.

WALTER MUCKLOW, *chairman*,
420 Hill Building, Jacksonville, Florida

EDWARD H. MOERAN,
120 Broadway, New York

J. HUGH JACKSON,
56 Pine Street, New York

Flack & Flack of Melbourne, Sydney, Brisbane and Perth (Australia) announce the opening of an office at Steamship buildings, Currie street, Adelaide, South Australia.

Naramore & Miles announce the opening of a branch office at 305 Proctor building, Troy, New York.

Current Literature

Compiled in the Library of the American Institute of Accountants

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The JOURNAL of ACCOUNTANCY

Official Organ of the AMERICAN INSTITUTE of ACCOUNTANTS

Vol. 34

NOVEMBER, 1922

No. 5

Taxation of Capital Gains*

BY GEORGE O. MAY

The treatment of capital gains under a steeply graduated income-tax law constitutes one of the most difficult problems in fiscal legislation as is sufficiently evidenced by the changes contained in successive revenue acts. Impartial students of the subject will, it is believed, agree that the present state of the law is not satisfactory, and among the remedies which are receiving consideration is the abandonment of the taxation of capital gains and of the allowance of capital losses as a deduction from taxable income. In Great Britain, where capital gains have not heretofore been taxed or capital losses allowed as deductions, the question is being debated whether some change in the law is not necessary on account of the avoidance of taxation of what is essentially income by clothing it in the garb of capital. The time, therefore, seems opportune for a discussion of the problem.

By capital gain is meant the profit upon the realization of assets otherwise than in the ordinary course of business, this profit being the excess of the proceeds of realization over the cost of the property realized.

In considering the proper treatment of capital gains under an income-tax law it is desirable to keep in mind three different causes which may make a capital gain possible. These are:

- (1) Change in absolute value due to natural growth or similar causes;
- (2) Change in relative value of property in comparison with other property, due to external causes;
- (3) Change in the money value of property due to depreciation or appreciation of currency.

In most cases of course a capital gain is due to a combination of these influences, some perhaps operating in a favor-

*A paper read at the annual meeting of the American Institute of Accountants, Chicago, Illinois, September 20, 1922.

able, others in an unfavorable, direction. All three, for instance, operating favorably might be found on the sale in the spring of 1919 of a privately owned barrel of whisky bought as new whisky in 1913. There would be, first, the increase in absolute value due to ageing, second, the increase in relative value due to the legislation enacted in January, 1919, and, third, the increase in money value, common to nearly all property, resulting from the expansion of currency and credit during the war.

Looking at the problem from the standpoint of principle, the gain due to the first cause is clearly only a special form of investment income and therefore naturally comes within the purview of an income tax. Gains due to the second cause are real gains, and therefore fairly taxable, even if not ordinary income. Indeed if discrimination in favor of earned income as against investment income is well founded, it may well be argued that these gains from unearned increment should be regarded as less entitled to consideration than ordinary recurring investment income.

Gains from the third cause are more apparent than real. There would seem to be no true income or gain from selling property at double its cost, if anything which can be bought with the proceeds is also selling at double its former price. This has been a common situation in recent years and has been complicated by the factor of involuntary sale or realization. In recent tax laws attempts have been made to meet it, first, by replacement fund provisions under which no taxable profit is deemed to be derived from an involuntary sale if the proceeds are put aside to be employed in replacing the property, and, secondly, by the provisions in the 1921 law permitting exchanges of property without any liability to taxes as a result thereof.

As a practical proposition it would be impossible to analyze every capital gain into its component elements and apply different rules to different elements. In particular it would be a hopeless task to convince the average taxpayer who had completed a transaction showing a loss, that he should pay a tax on the transaction because the loss was found upon analysis to be made up of an increase of value due to the first or second of the three causes above mentioned and therefore taxable, offset by a larger loss arising from the third cause and therefore outside the scope of the tax law.

The alternatives, therefore, are to tax all gains or to exclude all gains, except such as can be covered by simple rules. In considering the question whether capital gains should be taxed the successive points which arise are—

1. Is it in principle desirable to tax capital gains?
2. If so, should capital losses be allowed as a deduction from taxable income? And
3. If both the first and second questions are answered in the affirmative, how serious are the dangers of evasion and how far is it practicable to guard against them?

It must be understood that the danger of avoidance is not disposed of by excluding capital gains and losses from the scope of the income tax, as is evidenced by the movement in England already referred to. A majority of economists would probably take the view that capital gains are not a proper subject for taxation under the guise of an income tax. Apart from this technical point, however, it would seem that in principle capital gains would form a most appropriate subject of taxation and the supreme court has held that they can be taxed as income. Some theoretical considerations have already been briefly recited. Among other reasons which would have weight with a statesman as well as with a politician is the fact that the great accumulations of wealth by individuals in the country have largely been the result of capital gains, and the salary or wage-earning classes might quite naturally feel that they were being unjustly discriminated against if they were taxed on their salaries or wages and the large capital gains of the very wealthy should escape taxation. Moreover, even if the taxation of capital gains be regarded as necessarily involving the allowance of capital losses, it would seem that treating both on the footing of income would ordinarily be expedient in a developing country in which naturally the capital gains would far exceed the capital losses. This proposition is, however, subject to the important qualification that it holds only so long as the form and degree of taxation are not such as to discourage the realization of gains and encourage the taking of losses, and thus to cause a serious disturbance of the normal balance between gains and losses.

Turning to the second point, while it may seem that in justice the rules regarding gains and losses in a tax law should be as nearly as possible similar, it may be recalled that this principle has not usually been applied in our income-tax laws.

Even in the case of ordinary business until the enactment of the present law a taxpayer who made a profit on trading in one year and an exactly similar loss in another paid tax on the profit and obtained no relief in respect of the loss. As regards losses not incurred in the taxpayer's trade or business the act of 1913 allowed no deduction and the act of 1916 allowed a deduction only to the amount of the gains of a similar character included in the same return. The tax rates under these acts were, however, small as we now reckon tax rates and the problem becomes difficult only when taxes are large. In 1917 when the maximum rate of tax was increased from 15% to 67% the limitation on the deduction of losses contained in the act of 1916 was continued, but in 1918 when the maximum tax was still further increased to 77% all limitations on deductions of capital losses were removed.

Even under this law if a taxpayer pursued the even tenor of his way undisturbed, taking capital gains or capital losses as his judgment of present and prospective values dictated, and entirely uninfluenced by tax considerations, he was not in the position that tax relief resulting from a loss was exactly equivalent to the tax burden resulting from an equal gain. Such a taxpayer, if he incurred losses was thereby relieved from surtax at the rates he would have paid on his regular income; if on the other hand he made a profit he paid surtaxes at the higher rates applying to income in excess of his regular income.

Thus to take the case of a man who had a regular income in each of the years 1919 and 1920 of \$50,000 and sold one investment at a capital loss of \$20,000 on December 31, 1919, and another at a capital gain of \$20,000 on January 1, 1920, in 1919 he paid on an income of \$30,000 a total tax of \$3,890.00; in 1920 on an income of \$70,000 a total tax of \$16,490.00, together \$20,380.00. If however, both transactions had fallen in the same year he would have paid on an income of \$50,000 in each year a tax of \$9,190.00; a total for the two years of \$18,380.00 and his capital gain therefore cost him in taxation \$2,000.00 more than he saved on his capital loss though the tax rates were the same in both years.

However, this discrimination against the taxpayer was of relatively minor consequence compared with the wholesale loss to the government resulting from the fact that taxpayers liable to heavy rates of surtax very generally refrained from taking

profits, but not from taking losses. It is impossible now to estimate the loss of taxes which resulted from this disturbance of the normal policy of investors, but it must have been enormous. At the same time transfers which were desirable from the broad standpoint of public welfare were retarded or prevented. Men of advanced years, who were anxious to turn over their business affairs to younger and more vigorous men, were deterred from doing so by the tax which would have fallen upon them in the event of a sale; and in innumerable ways the ordinary course of business was effected by the artificial restraint on sales at a profit and the encouragement of sales at a loss.

To meet some phases of the problem, extensive new provisions were introduced in the act of 1921, mainly in two forms, first, the limitation of the tax on capital gains in the case of investments carried more than two years to 12½% and, second, provisions under which capital assets could be exchanged rather than sold without any tax being incurred. Under this law the rule that what is sauce for the goose is sauce for the gander invoked by taxpayers in support of the removal of the limitation on deductible losses in 1918 was waived in favor of the taxpayer. Logically the converse of the first provision just referred to would have been that a taxpayer sustaining a capital loss should pay the ordinary tax on his regular income and deduct therefrom 12½% of the amount of his capital loss. The act, however, permits him to save the maximum surtax he would otherwise have paid. Thus to use the same illustration as before, under the existing law a taxpayer with a regular income of \$50,000, a capital gain of \$20,000 in one year and a capital loss of \$20,000 in the next pays over the two years \$2,800.00 less than if both transactions had occurred in the same year.

In the case of the very wealthy, therefore, the present law makes it distinctly advantageous to take capital gains one year and pay a maximum tax of 12½% thereon and to take capital losses in another year, saving the maximum surtax to which the taxpayer would otherwise have been liable.

The position in regard to the exchanges is even more unfavorable to the government. A taxpayer holding stock of the A. B. Company desires to dispose of it and to reinvest in the stock of the C. D. Company. If the present market value of the stock of the A. B. Company is less than its cost to him he sells this stock and buys the stock of the C. D. Company and is en-

titled to a deduction from his taxable income of the loss on sale. If, however, the market value of the stock of the A. B. Company is above cost he arranges an exchange of this stock for stock of the C. D. Company with a cash adjustment and under the law he derives no taxable gain and therefore pays no additional tax.

From this brief summary it will be seen that in less than ten years the relation between the provisions regarding capital gains and those regarding capital losses has been changed from one of marked disparity in favor of the revenue to an even greater disparity in favor of the taxpayer. Probably every change has operated to the detriment of the revenue except to the extent that legislation has been retroactive and heavy taxes have been levied on transactions which would never have been consummated if a change in the law had been anticipated. Retroactive legislation, however, is not a desirable practice and while it was doubtless justified in a time of world warfare, it should be banned for the future like many other practices developed during the war.

The above history of legislation since income taxes became possible on March 1, 1913, suggests that though the disparity in favor of the taxpayers may be lessened, it would not be practicable even if desirable to restore the old disparity in favor of the government. It will be assumed, therefore, that if capital gains are to be taxed capital losses must be allowed as deductions on at least an equal basis. Though specific provisions may facilitate tax avoidance or make it more difficult, the treasury in dealing with all such problems suffers from the fundamental disadvantage that it is the taxpayer who not only decides the time and the form of transactions giving rise to capital gains or losses but exercises the option whether they shall take place or not. To use a military analogy, the initiative, whose value in warfare is universally recognized, is always with the taxpayer. The treasury has its fixed defences; the taxpayer moves only after careful study of these defences; and it is not surprising that the treasury, with a defence impregnable against a frontal attack often finds itself helpless against an enveloping movement which attacks it in the flank or rear. This disadvantage is increased by the fact that the distinction between ordinary income and capital gain is often a fine one, and a slight change in the form of the transaction may throw it into one class or the

other. If, therefore, the government decides to tax capital gains and allow capital losses as deductions, the taxpayer can refrain from taking gains but may take losses. If on the other hand the government should exclude capital gains and capital losses from the scope of the income tax altogether, there is danger of transactions which essentially give rise to income being cast into such a form that the gain would technically be held to a capital gain. How fine the distinctions are, and incidentally how unexpected may be the results to the government and to the taxpayer of any action outside the ordinary course of business in a time when tax laws are rapidly changing both in form and in degree of severity, is very well illustrated in the case of the *Phellis* or *du Pont* case. This case and the *Rockefeller-Prairie Oil & Gas* case, decided by the supreme court at the same time, constitute two of the most complete, and in amounts involved the most considerable, of the Pyrrhic victories of the treasury in tax litigation. The point at issue was not, of course, whether the transaction involved resulted in a capital profit or in a profit in the nature of ordinary income but what might seem a much simpler question, whether it resulted in any profit at all.

The amounts involved in the *Phellis* case are so large and its features so striking as to make it worthy of detailed consideration.

The facts are briefly that the *E. I. du Pont de Nemours Powder Company* of New Jersey in 1915 transferred all its assets to a Delaware company in consideration of debentures and stocks of that company and retaining debentures of the Delaware company equal to the par of its common stock (approximately \$30,000,000) distributed to its common stockholders two shares of Delaware company stock for each share of New Jersey company (or an aggregate of \$60,000,000). The market value of the Delaware company's stock at the date of distribution was \$347.50 per share. The supreme court has now found that this distribution was a dividend taxable to the stockholders of the New Jersey company and by this decision has added to the taxable income of 1915 an amount of approximately \$210,000,000, or nearly 5% of the total taxable income disclosed by all the individual tax returns of that year.

The five judges of the court of claims agreed in the view that in substance there was no income to the stockholders of the New

Jersey company because the stock of the Delaware company represented the same property and business as the stock of the New Jersey company had previously represented. This view was supported, however, by only a minority of the supreme court, the majority finding that both in substance and form the stock of the Delaware company constituted real income to the stockholders of the New Jersey company.

In passing it may be remarked that while each of the courts looked beyond the form and discussed the substance of the transaction—one finding that in substance there was no dividend, and the other that the whole of the stock of the new company at its market value constituted a dividend—in neither court was a third alternative discussed which seems most accurately to reflect the substance of the transaction. This alternative is that the stock of the new company represented substantially what the old stock had previously represented and that the old stock, which after the transaction represented only an equal amount of debentures of the new company, was the real dividend. In substance the position of the stockholder after the transaction was almost identically the position in which he would have been placed had the New Jersey company created \$30,000,000 of debentures and issued them to the common stockholders by way of dividend or even if it had sold \$30,000,000 of debentures at par and paid the cash to its stockholders. After the transaction the stock of the old company represented to the stockholder of the old or New Jersey company something severed from the du Pont property and business which he could realize without reducing in any degree his proportionate interest in the general du Pont assets.

The controversy extended over six years, during which anyone who was a stockholder at the time of the reorganization and who subsequently sold a part or the whole of his stock in the Delaware company was unable to determine whether under the income-tax law he had made a profit or loss by doing so. If, for instance, such a stockholder sold ten shares of the Delaware company's stock for \$2,000.00 the transaction would, on the government's theory, result in a deductible loss of \$1,475.00. If, however, the government's contentions were overthrown the result would be a taxable profit of a rather greater sum. The government having won, it is interesting to consider what this victory has gained for it and what has been or will be the cost.

The key-note of the decision by which the supreme court held that stock dividends were not taxable was perhaps the statement that a stock dividend provided nothing out of which the stockholder could pay a tax without parting with some portion of his interest in the corporation. Assuming that the taxpayers who were called upon in 1921 to pay surtaxes on the profits which they are deemed to have made in the transaction of 1915 should have had recourse to the sale of their stock to provide funds with which to pay their tax, what will their position be?

The market value of the stock of the Delaware company was at the time of the decision roughly par. Any holder who received his stock as a dividend in 1915 pays tax in that year on the basis of a value of \$347.50 per share, and if he sold in 1921 he is entitled to claim a loss on sale in 1921 of \$247.50 per share. In 1915 the normal tax was 1% and surtaxes beginning at incomes of \$20,000 ranged from 1% to 6%; in 1921 the normal tax was 8% and surtaxes beginning at incomes of \$5,000 ranged from 1% to 65%. It will be apparent, therefore, at once how great the advantages of the decision to a taxpayer may be. Taking by way of illustration the case of a married man without dependents whose income apart from the dividend in 1915 or sale of stock in 1921 was \$7,500 in each year, and assuming that he held 10 shares of the New Jersey company's stock and received 20 shares of the Delaware company's stock as dividend in 1915, and that he sold this stock in 1921 at \$100 a share, it will be found that the dividend does not bring him into the surtax class for 1915, so that he has no additional tax to pay for that year, but the loss of sale in 1921 reduces his taxes for that year from \$320 to \$2.

Multiplying the figures twenty-fold and taking a man whose income was \$150,000 in each year and whose original holding of the New Jersey company's stock was 200 shares, it will be found that the addition of the dividend to his income for 1915 increases his taxes for that year by \$5,950, and the loss on sale in 1921 decreases his taxes for that year by \$51,650.

The full effects of the decision are not reflected even in these figures, as had the opposite decision been reached there would have been a taxable profit instead of a loss on any sale of stock in the Delaware company. Presumably the decision will also involve considerable saving of tax to the Delaware company.

No doubt some stockholders had sold a part or all of their stock prior to 1921 and in other cases the stock is held by persons who would not, and perhaps could not without difficulty, sell any great proportion of their holdings. The cost of the victory to the government will, therefore, probably not come near its potential limits.

It is, however, reasonably certain that the cost to the government in the form of taxes lost will enormously exceed the additional taxes recovered as a result of the decision, and one is tempted to ask questions like those of the children in Southey's poem *After Blenheim*, and one finds no answer except Kaspar's:

"But what they fought each other for
I could not well make out.
But everybody said," quoth he,
"That 'twas a famous victory."

A similar analysis of the Rockefeller and Harkness cases would lead to a similar conclusion.

The claim of the government was at best largely technical since it could not be said that the du Pont stockholders realized true income from the transaction in an amount approaching the two hundred millions which the court held must in law be deemed to be derived therefrom. The case turned on the special facts of a very unusual transaction and established no new principle, and the net result in the particular case of the government's contentions being upheld was bound to be a loss of revenue. It is surprising therefore that the government did not accept the verdict of the court of claims.

The position after this decision and the stock dividend decision (*Macomber v. Eisner*) would have been most unsatisfactory if congress had not in the 1921 law provided in substance that no income should be deemed to be derived from corporate reorganizations.

The interest of the case in relation to the subject of this discussion lies in the evidence it affords of the room for wide difference of opinion concerning the income-producing effect of a transaction, even if the question is considered with regard to its substance and not merely to its form.

The room for difference of opinion on the question whether some of the complicated transactions of modern cor-

porate finance produce income in the narrower sense, capital gains or no gain or income at all is obviously even greater.

A study of the subject over a period of many years has led the writer to the conclusion that while either course is fraught with danger and tax avoidance on a large scale is bound to continue as long as high rates of surtaxes are maintained, on the whole the losses of revenue involved in the taxation of capital gains and the allowance of capital losses as deductions from taxable income are greater than those involved in the opposite course; further, that the margin is so great as to outweigh the consideration that in principle it is preferable to tax capital gains. Neither the war period, with its extravagant gains and unmerited losses, nor the period of readjustment immediately after the war was an opportune time for a change of policy in this regard. As, however, we get back to more normal conditions, such a change seems worthy of the most serious considerations, more especially as the existing law in remedying defects of the old law has created new opportunities for tax avoidance from which the government is bound to suffer very heavily.

If capital gains and losses are in general to be excluded from the scope of the income tax, safeguards will be necessary to prevent a wholesale escape from taxation of income by conversion into capital form. It is believed, however, that three provisions would be sufficient to prevent the great bulk of such evasion, namely,—

- 1—That where a capital gain or a capital loss arises in respect of an asset, which from its nature is subject to a natural increment or decrement in value, any gain shall be deemed to be income to the extent of a reasonable return on the investment for the period during which it has been held. Conversely the natural decrement should be allowed as a deduction from taxable income.
- 2—That where property is disposed of within, say, two years of its acquisition, the transaction shall be deemed to be a trading transaction and not a capital investment.
- 3—A provision under which the tax would be levied on the sale of stock of corporations, particularly private corporations, where it might appear that there was a profit which was attributable to the accumulation of undivided profits by the corporation and that the sale was made to avoid the imposition of the tax which would be assessed on such profits if distributed as dividends.

Of the three provisions it is believed that only the third would offer serious difficulty in its formulation and it should readily be possible to surmount these difficulties with the assistance of a group of persons familiar with business practice and with tax procedure.

Doubtless the adoption of this suggestion would involve the definite abandonment of a large amount of revenue which the government ought some day to receive, but it is not believed that the sacrifice of revenue which the government would otherwise be likely to receive would approach in amount the increase in revenue that would result from the elimination of deductions for losses.

Tax avoidance on a substantial scale would doubtless continue even if the suggestion were adopted, but this is bound to be true under any law so long as the extreme surtaxes now in force are continued. Most students of the subject are in agreement with the views expressed by the secretary of the treasury in his letter to the chairman of the house committee on ways and means of April, 1921, that the immediate loss of revenue that would result from the repeal of the higher surtax brackets would be relatively small and the ultimate effect should be an increase in the revenue. Congress apparently clung to the outworn idea that such a repeal would result in a loss to the treasury for the sole benefit of the rich. It will, however, ultimately be forced to recognize the shortsightedness of its policy, especially having regard to the existence of the huge volume of tax-exempt securities.

In justice to the present congress one must recognize that not only is the problem an extremely difficult one but it is made more difficult by the sacrifice of sound principles to political expediency in the original adjustment of income taxation to war necessities. Given a business world organized largely in the form of private companies which are practically incorporated partnerships, a world in which business transactions may readily be cast into different forms so as to produce ordinary income or capital gains, as may be the more advantageous, and given also a huge volume of tax-free securities—under such conditions the combination of a low normal tax on income of individuals and corporations with very high surtaxes is neither equitable nor effective.

This is equally true whether capital gains and losses are treated as entering into the determination of income or not. The form of tax avoidance changes to meet either rule. The only real solution is to reduce the disparity between normal taxes and surtaxes.

Had the congress recognized these facts in war time and raised the normal tax and the lower range of surtaxes to higher levels as urged by the treasury, it would have been possible later to make reductions all along the line. It is not surprising, however, that the present congress should look askance at a proposal to increase the normal tax and the lower surtaxes and reduce the higher surtaxes. Though in reality such a scheme would be sound finance and benefit the entire community it seems on the surface too much like a scheme to relieve the rich at the expense of the relatively poor to be expedient from the standpoint of party politics. It is certain, however, that the high surtaxes will prove increasingly ineffective and injurious the longer the present system is continued.

In the meantime, it is believed that the revenues can be increased, tax avoidance greatly diminished and greater equity secured by the abandonment of the rule of taxing of capital gains and, conversely, of allowing capital losses as a deduction from taxable income.

Why Should We Have a New Federal Tax Law?*

BY ROBERT H. MONTGOMERY.

Up to a short time ago, I favored a new federal income-tax law because the present law needs revision. I have changed my mind. The reasons for a new law are strong, even stronger, than ever, but the reasons against it outweigh the reasons in favor. It has often been said that a poor tax law fairly administered is better than a good law unfairly administered. I would add that a poor law interpreted by the supreme court is a more trustworthy foundation for business than an alleged good law in which every doubtful point is decided against taxpayers until the doubtful points reach the supreme court. A new law in 1923 would not be interpreted until 1926 or later. If we want a tax holiday we had better leave the 1918 and 1921 laws alone.

Therefore I do not propose to discuss the details of desirable changes in the present tax law. My thought is that when the time is propitious an entirely new law should be drafted, much shorter and much less complicated than the present law. What I mean by propitious is that there will be a reasonable chance that serious consideration will be given to suggestions. It is a difficult task to work out income-tax legislation and if suggestions are to be ignored or flouted it is not worth the effort. At this time it would be love's labor lost. Constructive suggestions pass from one man to another, each in turn less understanding than the former, finally reaching the neck of the bottle, the chairman of a committee, whose sole tenure of office arises from length of service. Quality of service has less to do with congressional power than in railroad unions. In the latter seniority sometimes is questioned; in the former there is no instance of promoting the capable man as such.

There are many sections of the 1916 and 1918 law which have not been authoritatively interpreted. The treasury has not been consistent in its regulations. Recently there has been a tendency to re-open settlements which were made under early rulings and procedure. Existing conditions in the bureau of internal revenue are far from satisfactory to taxpayers and to the responsible and capable officers of the bureau. Why, then,

* A paper presented at the annual meeting of the American Institute of Accountants, Chicago, Illinois, September 19, 1922.

have a new law or any changes in the present law until the existing congestion and confusion are at least partly cleared up? In my opinion conditions are worse today than they were one year ago, and they will be relatively worse one year from now unless something drastic is done.

I am not unmindful that a new tax law would greatly benefit the accounting profession. If we are against a new law, we are against our selfish financial interest. It requires some courage to urge simplification in tax measures, after reaping the benefits of a long series of complex laws; but the public accountant would not be a successful practitioner if he lacked courage, so we will talk and work against the new tax law just as we have worked and talked to improve those provisions of all previous laws which did not seem to us to be in the best interest of the business or taxpaying public. We were largely unsuccessful in our efforts but it was not our fault.

We may as well make up our minds that we shall not have a sane and practicable new tax law when those who have it in charge, who write it and who enact it into law lack clear vision and courage. Heretofore those who have finally passed upon the provisions of our tax laws have had their vision obscured by their personal political fortunes rather than illumined by the economic effect of the laws. We never know what takes place behind the closed doors of congressional committees, particularly conference committees. It has been said recently that public men are brazenly and cowardly whispering the truth in private instead of telling it openly. That is what takes place in Washington. Privately our congressional leaders admit the foolishness and impracticability of much that is before them to be enacted into law. Publicly, that is, through the medium of the *Congressional Record* and for publication in newspapers throughout the country, they say exactly the opposite for their constituents and for votes. Publicly they say that the public interests must be first, not private interests. In practice many private interests are well taken care of. This has been true in tax laws as in other laws. Taxpayers who have the ears of those who are most powerful in conference committees have been able to have special provisions inserted which take care of private concerns or special industries. Taxpayers who are not well organized and who do not have the ear of those powerful in legislation are left out in the cold.

The average senator, the average representative—being 99 per cent. of the whole body—has an obsession for re-election, which in reality is a disease of the most malignant nature. Soon after election he discovers the dreadful mistake the voters made in placing him in a position for which his qualifications are a minus quantity and the dreadful mistake he made in accepting. He has neither the courage to quit nor the courage to fight. The atmosphere in Washington inclines him with a pusillanimous attitude toward everything which requires common sense. He sees little evidence of common sense around him except in cases where men are not afraid of losing their jobs. He is fearful of doing anything different from the others; he submerges any inclination to be independent which he may have possessed when he reached Washington. And now his obsession becomes fixed; intelligence and courage vanish; he implicitly believes that he will be damned in this world and the next if he is not re-elected. His pride is aroused; he becomes frantic. Even though the next election is six years ahead, the obsession allows no interval of sanity. The realization and conviction (which he tries to hide from the world) that he is an utter failure as a legislator urges him on in efforts to avoid detection of his short-comings.

We had a good illustration of this cowardice in August. President Harding asked congress to enact laws which would help solve business troubles. Did the legislators discuss the questions on their merits? They did not. The newspapers interviewed them and the replies were almost unanimous. The *New York Times* summed up the situation in these words:

“Leaders believe too many dangerous issues are already before the public.”

In other words any issue which affects capital or labor is dangerous. Therefore, it must not even be debated. Senators and representatives concede that “something” should be done, but no emergency is so acute or alarming as the November election; nothing can be done which possibly would decrease the campaign contributions expected from capital or affect the labor vote. If capital can be scared and labor can be placated, the settlement of fundamental problems can go hang.

The men to whom powers are given almost invariably seek to extend these powers. It becomes part of the obsession. To keep themselves in power they will pass only those laws which

assist or appear to assist this object. A confiscatory tax law appears to tax the few rich for the benefit of the many poor. Until the composition of the congress changes we shall have confiscatory tax laws.

Commencing with the federal revenue act of 1913 all our income-tax laws have been deliberately aimed at successful industry. Congress has proceeded on the theory that all large profits are illegitimate. The most popular vote-seeking word on the floor of congress, used by Republicans and Democrats alike, is "profiteer". A "profiteer" is a man who makes a profit, ergo he is a crook and the profit must be extracted from him by a new tax law.

Congressmen are a poor sort of office or errand boy. They are a poor sort because they do as much running around as the average errand boy but they do not get proportionate results. The promises which they make to their constituents cannot be kept. They promise 100 jobs when they can deliver ten. They pass on to the various government agencies the 100 promises, and the agencies, in turn, not to offend the congress, promise 100 jobs. So a vicious circle is started. Congressmen do more running around in it than the departmental chiefs. This I know from personal experience. They are so stupid that they do not read in the history of the world that the rulers and representatives who are loved and blindly supported against the field are those who make many mistakes, who acknowledge weaknesses, who do not bluff nor cringe nor promise the impossible, but who above all have one trait which dominates them, namely, courage.

In a recently published letter of the tsaritzza to the tsar appears this sentence, "Everybody who really loves you wants you to be firmer and more resolute". It is the dominant cry of the ages. Why is the trait almost lacking at this time in public affairs? Both business-men and congressmen are constantly excusing themselves for lack of courage, for lack of action, when courage and action are important, by the plea: "We can't make an issue of this one point; we must wait until we can afford to go to the mat". It is enough to make one sick. They never go to the mat although ninety-nine and nine-tenths per cent. of their constituents love a fight. Congressmen do not remember that people love both winners and losers; all that people insist upon is that one must fight.

It is a mistake for the business-man not to fight for those things which he knows are beneficial both to himself and to the business public as a whole. Having paid the cost of electing representatives, the business-man should demand some attention to the carrying out of promises, and, failing to receive reasonable consideration, should talk to congressmen the way congressmen talk to business-men. But the business-men also lack courage. I have seen many of them treated like dogs in Washington and they have not even talked back. The reason they do not talk back is this: Business-men know that they have paid in advance, in full, for something (they are never quite sure what they pay for in politics), and their thrifty natures lead them to avoid too many complaints in the fear that their man or men, that is the congressmen, will become annoyed and refuse to do anything at all.

I would not want it understood that the contributor to a campaign fund is entitled to any more consideration, or any more of a hearing, or any more influence than one who refuses or cannot afford to contribute; the contributor is not entitled to preferred consideration, but he should not be double-crossed.

On this point the *New York Herald* recently said:

"The disheartening thing in governments is the chameleon nature of politicians—statesmen. In the campaign for election, with alluring promises they beg you to take them on in your service; installed in your service they give you the lash of the master. In the campaign for election they beseech you for a job; installed in that job they tell you where you get off."

A few months ago when Lloyd George said in the house of commons, "It is a mistake because of danger to run away from a fair and just claim," he was cheered. In this country there is too much running away. Congressmen habitually run away when there is any danger of losing two votes, when they believe that the support of a fair and just claim means only one vote. Business-men have been running away because demagogic congressmen scare them into thinking that if they do not keep quiet something awful and mysterious will happen to them.

This reminds me of the story about the Chinaman who was doing business in the United States. He wanted to collect an account and he did not know just what kind of a threatening

letter to write. Finally he wrote this: "If you do not pay this bill immediately something will happen which will cause you the utmost astonishment". It sounds like a letter from a congressman or from the treasurer of a campaign fund. It is this fear of something mysterious which keeps the business-man from demanding what is his due or withdrawing his financial support from his party.

The American business-man in political matters is a dumb-bell. He pays the expenses—and they are enormous—of his political party. When his party becomes dominant and he asks for intelligent legislation, he allows himself to be deceived by statements that all that can be done will be done in due season. Measures will be enacted at some subsequent, never the current, session of congress. I refer only to subjects which have been specially approved in party platforms or similarly have been agreed upon as desirable and unobjectionable. I think it safe to say that in the last fifteen years, congress has not averaged one good law per annum affecting business-men. If the legislation demanded by business-men were inimical to the best interests of the country at large, there would be full justification for the refusal and neglect. But the curious and amusing fact is that good or beneficial legislation is the hardest to put through. Congressmen see nothing in it for themselves. Many laws are passed which are not of general interest or importance. Contributors with courage sometimes collect more than they are entitled to. By occasionally delivering something on account, the congressman keeps his reputation for activity. His activity is another pose. From year to year the pages of the *Congressional Record* are filled with absolute quibble. They use up more space in the exchange of personalities than in any discussion of important or economic questions. The output of unimportant stuff is enormous. It runs to billions of words. The output of good stuff which in the slightest degree is interesting to the average business-man is so negligible that a supplement to the *Congressional Record* once a year consisting of about forty-eight pages would give everything that could be called constructive. I have not exaggerated this comparison of quantity with quality. Can anyone remember a single constructive or beneficial bit of legislation enacted at the present session? Yet the current issue of the *Congressional Record* before me includes pages 12233 to 12290. (Who knows when congress will adjourn?) They start with

page 1 at each session. If they did not, they would need a wider page after a few years. And we are told that practically all of the real (the word should probably be spelled "reel") business in Washington is conducted in committee meetings, whose proceedings do not appear in the *Congressional Record*. If anyone is interested in this matter of word-output, look up the expenditures of the public printing office.

Is it fair to say that our own output of words produces anything worth while? The answer to this is that our representatives in congress are supposed to be specialists in public affairs. They are supposed to spend all of their time and energy in the study of questions of public interest. They are supposed to be conversant with national as well as international problems. Unfortunately, our criticisms of congress are usually destructive criticisms. Unquestionably, we should confine ourselves to constructive criticisms. But you cannot reconstruct an utter failure. I make no apology for my strictures upon the makeup of the present congress or those which have preceded it during the last dozen years. I rest my strictures upon an impregnable foundation. I have the very highest authority for my statements that nothing of any importance constructively is accomplished from day to day. I also speak largely from personal experiences in Washington. Much that I say is based on first-hand information. There are a few, very few, senators and representatives who once in a while are constrained to tell the truth.

It is conceded that one of the ablest men in congress is Senator Borah. He has been there long enough to know the exact truth about what is going on. If he makes a well-considered statement which is uncontradicted, it may be assumed by the layman or outsider that it is literally the truth. If it is admitted in Washington by those who know that we have too many poor laws, that our taxes are too high, that extravagance is rampant, and if the business public as a whole knows definitely that it is so, why then is it not possible to do something constructive? Why can't we insist on some relation of output to the time or words consumed, say one good law to each billion words? People who get their living from public funds and contributors to campaign funds are responsible for the present situation. Let us consider a few plain facts made public by Senator Borah. I shall quote at some length from his speech delivered in the

United States senate, July 6, 1922, because I want to emphasize and repeat that what I am saying is based on facts and not on fancies. After that we can consider the remedy.

... Not a single one of the measures upon the programme which is now before us but draws upon the people for an additional sum and weighs upon them in the form of additional taxation and increases the obligations of the government not only by millions but by billions of dollars.

Mr. President, therefore, while I have sat here and listened to this debate or while I have known that it was going on, I have not felt the impatience which I otherwise would if I knew that there would follow the tariff bill measures which would, in my judgment, afford relief to the country. I ask our friends who are meeting at the headquarters of our leaders if there is a single item in this programme that does not increase the taxes of the people of the country? Is there a single part or parcel of the programme that does not increase the obligations of the government? It is the character of the programme which makes hesitancy and delay in the consideration of the tariff bill a virtue.

Mr. President, we know that there is already great discontent throughout this country, and when discontent is widespread it is never without justification. That condition is apparent in the United States and it exists throughout the world.

It is evident that the burden which governments continue to impose upon the people is becoming unbearable. It is getting, as it were, upon the nerves of the public. The first underlying cause in my judgment of the world-wide unrest, of the almost universal criticism which we hear against governments, is exorbitant and unconscionable governmental expenditures, and particularly the outlook that these expenditures are not being diminished to any appreciable extent. Indeed, I do not believe that the burdens already placed upon the people are so disturbing, so fruitful of dissatisfaction and discontent, as those burdens which present policies indicate are yet to come. The present demands are sufficient to take people's earnings, but the proposed policies take away their hope for better days.

The protest upon the part of the people is now being manifested in this country and throughout the world. It makes itself known in strikes, through the ballot box, and finally in rioting and bloodshed. The most prolific source of misery and crime is oppressive taxation, and when you stop to think of the load now carried by the masses, we can not be surprised at the disorder and lawlessness everywhere prevailing.

In some countries it seems to be believed that this discontent and hunger can be fed upon repression and executions. In other countries, particularly our own, the belief seems to prevail that the remedy is in still greater appropriations, increased national obligations and necessarily higher taxes.

The author of *The Mirrors of Washington* is conceded to be extraordinarily well informed regarding our lawmakers. This is what he says about congress:

"For years it has been the home of small men concerned with petty things which it approached in a petty spirit, incompetent, wasteful and hypocritical, a trial to the executive, almost a plague to the country."

What is the remedy for the inexcusable extravagance and waste which Senator Borah says is too greatly extended? Is it a new tax law, with further penalties on success and thrift? It is often said that the remedy lies in the vote, but I doubt it. In my opinion, the remedy lies in the temporary withdrawal of campaign contributions by business-men.

My suggestion is that Republican and Democratic business-men alike refuse to contribute a single dollar to either party unless and until legislation has been enacted—not promised—which means lower expenditures. Then we can have lower tax rates. After that and not before business-men should demand a new tax law.

In the meantime, congress should not be permitted to *change* the present law by so much as a comma. We should not trust our representatives until by repentance and good conduct they show themselves worthy of trust.

Our representatives claim that in this country the majority must rule, that the corner-stone of our republic is the principle of representative government and that majorities express their wills through chosen representatives. The rights of the great body of citizens are thus in theory protected by those who devote their time and talents to supervisory duties and the enactment of beneficial laws.

It is claimed that the minority acquires more wealth than the majority of the people and more than a fair share of the wealth of the world. Therefore, these representatives of the majority think they must do one of two things: take it away from those who have and give to those who have not, or have the government take it away and use it for the good of all.

In reality they do nothing logical. They have invented a way of their own. They do take it from those who have and in a sense those who have not may get a little of it when it is wasted. Most of the money which is taken away from the rich is spent by the government, not held for the good of anyone, because the spenders and recipients of ill-gotten wealth rarely benefit therefrom.

We are probably the only country in the world, except Russia, where discrimination is exercised in favor of the idle rich against the industrious and productive rich. The idle rich are permitted to buy tax-free securities and live in luxury free from a proper share of the burdens and cost of government. When

there is a premium on idleness and waste, why attempt to create new wealth, if all of the wealth which you create is to be excessively taxed or taken away from you in some other way?

Congress in practice disregards the ethics of election methods. In public they make much of the use of improper methods. In public they assail the wicked rich minority. At election time they depend upon the contributions of precisely the same minority to elect them.

If the pure and poor majority want representation to protect themselves against the corrupt and rich minority, why do not the minority compel these representatives to look to the majority for election expenses?

If the representatives are in duty bound to legislate for the majority why do they need or accept help from the minority?

We follow Russia's lead in damning and taxing the industrious rich, but so far we have not followed her lead in killing the idle rich. I hesitate to mention this, because I feel sure that it is a thought which will appeal to some of our congressmen and many of their constituents. When they realize the vote-getting potentialities and how few men there are to kill compared with the possible number who will be pleased, we may expect some weird new laws. Men of ability, of daring and superior imagination must not be allowed to accumulate wealth! Shall they be taxed to death or locked up?

Some who have given much thought to the subject favor the repeal of income taxes on business and the substitution of a tax on gross receipts. It may be worth while to try it. It would be no worse than the excess-profits tax.

I have an open mind on a turnover or general sales tax. The arguments of the proponents are highly inconsistent and are weakened by overzeal. There is no agreement on the exceptions. If farmers and bankers and professional men and many others are not subject to the tax, it would seem to throw an undue burden on commercial business. I am not convinced that one or more billions of dollars when extracted from gross income is less of a burden than if it is imposed on net income. I am not sure that the tax can be passed on when it is vitally important to do so. When large profits are being made no doubt the tax can be passed on, but when a corporation is earning large profits a tax of 12½ per cent. of such profits is not oppressive. When a business is losing money or making very little I feel quite confident that

there will be difficulty in passing a sales tax on. If it is within the power of business-men to pass on increases in prices, why haven't they done more of it during the last year or two? Raising and passing are troublesome factors in business as well as in other pursuits. If the sales tax cannot be passed on, the burden will be vastly greater than a 12½ per cent. tax on net income.

I am not impressed with the records of sales-tax experiences in our own and other countries. The Philippines and Mexico are held up as successful users of a sales tax. It has been so successful in the Philippines that they are about to double it! In Mexico, on authority of one of its financial officers, it was largely helpful in the rehabilitation of the country's finances! The officer says in a letter addressed to the Tax League of America, dated April 15, 1921:

The amount of the tax at present is one-half of 1 per cent. This tax has been in existence so long, and the people have become so thoroughly accustomed to it that it is collected without friction or difficulty of any kind and on account of the amount being so small the customer pays it unconsciously. It is economically collected and uniformly produces a very important item of the revenue.

Secretary Mellon must be stubborn, because he has refused to recommend it in the financial plans for the financial rehabilitation of this country. Of course, he may be ignorant of the fact that Mexico ever did rehabilitate her finances, either through a sales tax or in any other way.

For the present we are not likely to have a sales tax in the place of all other business taxes. But the possibility of the enactment of such a law is another argument against any change, during 1923, in the present revenue act.

A few days after I wrote the foregoing, the *Wall Street Journal* contained the following:

Wall Street has been so long disfranchised that it is inclined to take less interest in election results than politicians suppose. The same could be said for the general business of the country, but with reservations. People in the wool-growing business, for instance, want favors from congress and are willing to pay for them. No doubt the beet-sugar interests will come across with a handsome contribution for the expenses of the November election. But the only favor Wall Street would be willing to buy from congress, through campaign contributions, would be the assurance that congress would refrain from meddling with what it doesn't even want to understand. * * *

So far as the members of the house of representatives and the senate are concerned, the overwhelming part of the business of the country not interested in tariff favors owes them no thanks.

To those greatly influential business men who read *The Wall Street Journal* it is therefore said that in the forthcoming election

Why Should We Have a New Federal Tax Law?

they should not subscribe a single penny toward the election of any candidate. The proportion of such candidates with any sound business principle or sense of proportion is so small that it is not worth consideration. Congress has done its worst to us. Campaign contributions now are merely blackmail. But if the men who can afford contributions will consistently refuse to make them we shall soon have a different kind of politician. He will realize that he should be part of the prosperity of the country, with its government conducted on strong and sane lines. It is obviously better that this lesson should be learned now rather than in 1924.

It is thus evident that serious consideration is being given to the mistakes of the past. When those who contribute to campaign expenses can be assured that business will receive a square deal it will be time enough to talk about a new tax law.

Taking the Examination

BY J. HUGH JACKSON

During recent years there has been a great deal of discussion, both oral and written, concerning the prevalency of failures among those who have sat for the American Institute or for various C. P. A. examinations. The percentage of failures has been entirely too large—nearly everyone agrees to that—but there has been by no means a unanimity of opinion as to the real cause or causes of these failures. Certain critics have been prone to place the blame upon the various boards of examiners, believing that the questions asked have been too long or too hard, or have not been clearly stated, or for other reasons have not been a fair means of testing the applicant's right to be admitted into the membership of the Institute or to be certified as a public accountant in the state where he has made his application.

A study of the recent examinations set by the American Institute of Accountants must lead one to the conclusion that the examinations have not been too long or too hard. Furthermore, where two or more interpretations might have been placed upon a problem (and such problems have been comparatively few) the writer is frankly of the opinion that any reasonably sensible interpretation and any reasonably sound solution would have been taken by the respective examiners as an acceptable answer. It must be acknowledged that the above is only a matter of personal opinion, but is it not reasonable to believe that any group of leading accountants of any state body or of the national organization would impartially and with all fairness give every consideration to the examinee? We believe this is the only fair assumption that can be made, and we believe further that if a roll-call were taken of everyone who has taken the Institute or similar examinations within recent years—regardless as to whether the examinees were successful or not—fully ninety per cent. of the applicants would say unhesitatingly that the examinations were entirely fair and that the marks received were all that could have been expected.

Contra critics, however, have maintained that the large percentage of failures resulted mainly because of the inexperience or other unpreparedness of the applicant. It is true that some are not by nature or by training qualified to do public accounting work, some have had insufficient training, while others are

lacking in experience—but are any of these reasons the major cause of so many failures? We believe not. The training and other qualifications of an applicant are supposedly quite carefully inquired into, and it cannot be maintained that boards of accountancy everywhere are negligent in this respect. Is it not also true that many applicants who fail miserably in such a written examination would have little or no trouble in performing similar work on an assignment? And, on the other hand, are there not those who do well in an examination but are largely lacking in the experience necessary to do the same work on an audit? In an increasing number of cases undergraduates in university courses in accounting have been successful in passing certain state examinations, though they have had no practical accounting experience. Is it experience alone which is lacking or is necessary?

What is it, then, which hinders most the applicant in passing his examination? It is undoubtedly partly due to a lack of knowledge of accounting, and partly to lack of accounting experience, but more than either of these we believe that such failures arise from a lack of knowledge of *how to take an examination*. It is this which we intend briefly to discuss, in the hope that it may prove of material assistance to those contemplating taking the Institute or other examinations.

Obviously, one need not only to know his subject, but also to have in his own mind an orderly arrangement of the material on the subject, if he is to be successful in any written examination. But more than that, the examinee must have *confidence in himself* that he knows his subject. He should think of the examination largely as he would think of an assignment of his firm, and of the examiners as he would of the client. He should forget that it is an examination and thus he will succeed much more easily than if he becomes nervous and excited about it before the examination begins.

Do not study up to the last minute, but rest and thoroughly relax at least one day before the examination. Thus one will come to his examination well prepared to do clear and effective thinking. He should endeavor to do no studying, or as little as possible, between the sessions of the examination, but rather save his strength for the examination itself. Instead of studying between the daily sessions of the examination, let him take a brisk walk in the open air—keep himself physically fit.

The following suggestions, then, are presented with reference to the actual examination and it is believed they will be found of assistance, particularly to those who are not accustomed to taking examinations. They are as follows:

1. Know definitely in advance the exact time allowed for the particular sessions of the examination, that is, when the examination is to begin and how many hours are allowed for its completion.
2. Be certain, before going to the examination to have plenty of working materials—two fountain pens, or several well-sharpened pencils should be available.
3. The examinee should lay his watch out before him, and work by his watch.
4. Upon receiving the examination questions he should—
 - (a) Note specifically how many questions must be answered, and if certain questions (and which ones) are required;
 - (b) Read through the entire set of questions, and note (at least mentally) which questions he intends answering;
 - (c) Allot the time to the individual questions somewhat in accordance with the credit which is to be given each question (for instance, if there are five questions to be answered in four hours, it may be that the first question will require approximately one hour, the second question two hours, and the other three questions twenty minutes apiece). In case more credit is to be given one question than another the examiners usually state the relative credit which each question is to receive.
5. The examinee is now ready to begin actual work (twenty to thirty minutes out of four or five hours may be very profitably spent in the preliminary survey). He should work steadily, but not too rapidly. Do not try to hurry, for that will almost surely cause one to make an error or to omit some important point.
6. In taking up each individual question, he should *first* read it entirely through. Try to determine what point of principle or procedure the examiner wants to illustrate in that problem, and then "hit it hard." Endeavor

to work intelligently, and not in the dark as to what is wanted. Answer fully, but briefly, every point in the problem, but when an answer is completed and the examinee has given the reasons for it, he should *stop*. A good answer may be easily spoiled by unnecessary additions, which show that after all the examinee did not fully understand the problem.

7. In case two or more interpretations can be placed upon the problem, or in case there are two or more ways of handling an item, the examinee should give *briefly* the several possibilities and should state *definitely* which interpretation or method he has chosen, and why he has chosen it. (Illustration: Discount on sales may either be deducted from gross sales, or may be treated as a selling expense, or may be considered a financial transaction. Recently an examinee, in one state C. P. A. examination, deducted discount on sales from gross sales; a transcript made of the examination paper showed that the examiners had marked it "wholly wrong," and had failed him on that problem. If the several possible methods had been stated, the examinee might have been more successful.)

Likewise, if in doubt as to the meaning of a question, the examinee should state briefly his understanding of it and give his answer. Then he should explain *briefly* how any other construction would affect the answer.

8. Follow instructions, and endeavor to visualize exactly what happened and the sequence of the transactions. If journal entries are requested, the examinee should put the answer in the form of journal entries, regardless of his own ideas as to the best method of stating the solution. Record what happened in as clear and logical a way as possible—each statement or account should be clearly stated and should be properly set off by *itself*.
9. When the allotted time has been given to one problem the examinee should stop *at once* and take up the next problem or question. (In case only a few minutes more will complete the problem, the examinee is of course supposed to show judgment in his action, but ordinarily the next problem should be taken up at once.) Upon the completion of the other problems or questions, if

there is yet time, the examinee may return and complete the former problem. In general, it is safe to say that the examiners are more interested in one's grasp of fundamentals than that he should get every answer arithmetically correct; and a candidate will stand a much better chance of passing his examination if he brings out the real points in all the questions—even though slight errors may exist in the results.

Yet the examinee should be careful in regard to technique, or to the mechanics of his work. The neatness of the work will make a decided impression upon the mind of the examiner, and careless work will involuntarily mark the examinee as slovenly and careless in his habits of thinking. Writing should be plain, and figures not crowded.

10. Upon completing the examination paper one should go over the answers carefully, and not hurry away from the examination. Many a man has saved his examination by just this procedure, and if time remains to do so no examinee should even think of leaving an examination without carefully reviewing his paper.
11. *First, last, and all the time, keep cool—Do not lose your head.* If one feels that he is about to “blow up” he should just lay down his pencil for a few minutes and absolutely forget the work. It may be that he needs the time, but a few minutes' relaxation will be the best thing he can have, both for himself and for his examination.

The individual who has never experienced the strain and weariness of a long examination, oftentimes not only requiring high-grade technical knowledge but as well a struggle against time, little appreciates what it means. The real point is, however, that while it may be difficult it is far from being impossible, and the accomplishment is well worth any sacrifice made. The examinations have been passed and they will continue to be passed; any individual with an adequate knowledge of accounting and of the kindred subjects, with the required amount of experience, with reasonable confidence in himself, and with a knowledge of how to approach an examination may feel reasonably certain of obtaining his Institute or C. P. A. certificate whenever he makes the attempt.

The JOURNAL of ACCOUNTANCY

Official organ of the AMERICAN INSTITUTE OF ACCOUNTANTS

A. P. RICHARDSON, *Editor*

EDITORIAL

Regulation of Security Issues

The president of the New York Stock Exchange, Mr. Seymour L. Cromwell, in a recent address discussed the subject of publicity in connection with the issuance of securities and the remedies for bucketshops and fraudulent stock promotions. Mr. Cromwell recognized the evils that exist and the responsibility resting upon the stock exchanges in connection therewith, and pledged the important exchange which he represents to full co-operation in carrying forward a sane programme of reform. After discussing the defects of various measures, which have been proposed, Mr. Cromwell, as reported in the daily press, urged the following constructive measures:

"Our position," he said, "is simply this:

"If we are to have new legislation, let us make sure that the new laws really get down to the root of the evil. We already have punitive laws. Let us find additional ways of making such laws applicable to offenders and of making their enforcement more easy.

"A simple way of getting right down to the bottom of our problem would be the passage of a law requiring full publicity in connection with the issuance of securities and the status of the issuing companies. That is in line with the English practice.

"Require that sworn statements be filed prior to the issuance of securities and semi-annually thereafter, and that the statements give adequate information concerning the flotation and the financial position of the issuing companies or parties, and also concerning their operations and earnings. That would strike a vital blow at the fake promotion because you would get the jump on it from the start.

"Officials of companies whose securities are offered for sale would immediately lay themselves open to punishment and could be easily reached by the present laws if they furnished doctored

information to bolster up a swindling promotion. Let us pin the responsibility where it belongs, on the people who furnish the background for the dealer in fake securities, and we will soon make it impossible for such dealers to operate.

"That kind of legislation the stock exchange will support—something that is simple, direct, easily enforceable and that will really give protection to the public."

Most reformers in this field have spoken with more zeal than knowledge and have urged legislation which would be too far-reaching and bound, therefore, to be ineffective. Human nature being as it is, financial speculation can not be abolished; indeed, economic progress would undoubtedly be retarded if it were abolished. The pioneer in every field is in a sense a speculator, although it does not necessarily follow that every speculator is a pioneer. If people wish to invest in speculative securities they are entitled to do so. They may be foolish and perhaps ought to be dissuaded from their course, but such work does not belong to the legislature. What can and should be done by legislation and effective public administration is to throw a light of publicity upon the issuance of securities that will enable investors to judge for themselves whether a given security is sound or whether and to what extent it is speculative. The investor has a right to invest in a speculative security, but he is wronged when a speculative security is represented to him as a sound, conservative investment. Further than this he is entitled to be protected against secret contracts or arrangements among those on the inside.

Mr. Cromwell does not present his programme as something new or novel but states that it is along the lines of the English practice, and he might have added truthfully that this practice has worked well for many years. The provisions of the English companies act relating to this general subject have to do with (a) prospectuses, (b) reports required from companies, and (c) the audit of the accounts submitted to stockholders, and at the risk of repeating what is familiar to many of our readers the more important of these provisions are given as follows:

PROSPECTUSES

Sec. 81—(1) Every prospectus issued by or on behalf of a company, or by or on behalf of any person who is or has been engaged or interested in the formation of the company, must state—

- (a) the contents of the memorandum, with the names, descriptions, and addresses of the signatories, and the number of shares subscribed for by them respectively; and the number of founders or management or deferred shares, if any, the nature and extent

- of the interest of the holders in the property and profits of the company; and
- (b) the number of shares, if any, fixed by the articles as the qualification of a director, and any provision in the articles as to the remuneration of the directors; and
 - (c) the number and amount of shares and debentures which within the two preceding years have been issued, or agreed to be issued, as fully or partly paid up otherwise than in cash, and in the latter case the extent to which they are so paid up, and in either case the consideration for which those shares or debentures have been issued or are proposed or intended to be issued, and
 - (f) the names and addresses of the vendors of any property purchased or acquired by the company, or proposed so to be purchased or acquired, which is to be paid for wholly or partly out of the proceeds of the issue offered for subscription by the prospectus, or the purchase or acquisition of which has not been completed at the date of issue of the prospectus, and the amount payable in cash, shares, or debentures, to the vendor, and where there is more than one separate vendor, or the company is a sub-purchaser, the amount so payable to each vendor: provided that where the vendors or any of them are a firm the members of the firm shall not be treated as separate vendors; and
 - (g) The amount (if any) paid or payable as purchase money in cash, shares, or debentures, for any such property as aforesaid, specifying the amount (if any) payable for *goodwill*; and
 - (h) The amount (if any) paid within the two preceding years, or payable, as commission for subscribing or agreeing to subscribe, or procuring or agreeing to procure subscriptions, for any shares in, or debentures of, the company, or the rate of any such commission: provided that it shall not be necessary to state the commission payable to sub-underwriters; and
 - (i) The amount or estimated amount of preliminary expenses; and
 - (j) The amount paid within the two preceding years or intended to be paid to any *promoter*, and the consideration for any such payment; and
 - (l) The names and addresses of the auditors (*if any*) of the company; and
 - (m) full particulars of the nature and extent of the interest (if any) of every director in the promotion of, or in the property proposed to be acquired by, the company, or, where the interest of such a director consists in being a partner in the firm, the nature and extent of the interest of the firm, with a statement of all sums paid or agreed to be paid to him or to the firm in cash or shares or otherwise by any person either to induce him to become, or to qualify him as a director, or, otherwise for services rendered by him or by the firm in connection with the promotion or formation of the company.

REPORTS AND AUDITS*

106. Once at least in every year the directors shall lay before the company in general meeting a profit-and-loss account for the period since the preceding account or (in the case of the first account) since the incorporation of the company, made up to a date not more than six months before such meeting.

107. A balance-sheet shall be made out in every year and laid before the company in general meeting made up to a date not more than six months before such meeting. The balance-sheet shall be accompanied

*Note: Similar provisions appear under section 94-A of the Dominion companies act (1908) as amended in 1917 in Canada.

by a report of the directors as to the state of the company's affairs, and the amount which they recommend to be paid by way of dividend, and the amount, if any, which they propose to carry to reserve fund.

108. A copy of the balance-sheet and report shall, seven days previously to the meeting, be sent to the persons entitled to receive notices of general meetings in the manner in which notices are to be given hereunder.

109. Auditors shall be appointed and their duties regulated in accordance with sections one hundred and twelve and one hundred and thirteen of the companies (consolidation) act, 1908, or any statutory modification thereof for the time being in force.

Under the foregoing provisions the most speculative enterprise can be floated and anyone familiar with the prospectuses appearing from time to time in England is struck by the number of highly speculative issues; but the investor in such securities knows that he is taking a risk and he also knows that the company officials, promoters and bankers are responsible for the representations made to him. In like manner an investor seeking a safe investment can identify that article, and all investors know that a high standard of good faith is required of everyone who offers securities to the public. This is the end to which we should aim, and the recommendations made by Mr. Cromwell are timely and wise.

Federal Tax Problems

Federal taxation was the subject of two of the papers presented at the September meeting of the American Institute of Accountants and both of them appear in this number of *THE JOURNAL*. Mr. Montgomery does not, indeed, discuss taxes so much as the attitude of members of congress and American business men toward the subject. Business men could influence congress if they would think through financial and economic problems. They ought to be able to advise upon these matters, but when business men appear before congress or its committees they too often come seeking a benefit for themselves or their trade-group or else they want to show how to place a burden on some other group. It is not strange, therefore, that business men fail to influence legislators more than they do.

The fact is that our tax problems are so complicated that there are few men in or out of congress who have gone far below the surface. This is excellently illustrated by the fact that upon so fundamental a question as that of the taxation of capital gains there is still room for difference of opinion. Mr.

May's paper upon this subject certainly shows that our attempts to tax such gains as income have produced highly imperfect results. When a few years ago, we adopted the income tax we decided, with substantial unanimity, to tax capital gains and now we are not happy over it. England, with a much longer experience in income taxation, has not taxed capital gains, but of late she has shown signs of uneasiness over her methods.

During the war it was often said that the world was going to be different, and, while we now have less optimism about the kind of new world, we realize that the world is different, and in nothing is it more different than in its tax problems. To compare pre-war tax laws with the provisions of the revenue act of 1921 is like comparing the "one hoss shay" with a high-powered motor car. At first we thought the problem was one of rates, and in a sense it is, but we now find that high rates bring a whole train of circumstances in their wake—things which nobody thought of before and not the least disconcerting of the lot is the fact now amply proven that very high rates tend to defeat their purpose and soon lose productivity. Perhaps it is something like the old law of nature which provides in the animal world that as the scale of intelligence increases the rate of productivity decreases.

It will probably take years of practical experimentation to determine the best tax policy. Little light is thrown upon the subject by past experience; and we have been and still are facing what is in fact an entirely new problem, although it came to us clothed in the garb of an old problem. The amount of revenue that must be raised by taxation is so staggering that all our tax machinery was inadequate and it is not to be marvelled at that our first and somewhat hastily devised plans have not worked entirely well. In perhaps no other field of human effort is there a wider difference between theory and practice. In theory the excess-profits tax can be defended. It is logical and appears to be sound. In practice it has proved to be impossible, except during war time and as a war measure. As a permanent institution its machinery is too complicated to work. The real argument against an excess-profits tax is found, therefore, not in theory but in its impracticability. Much the same considerations apply to the allowance of a deduction for depletion in computing taxable net income. In theory such a deduction seems imperative but in practice it involves questions

of valuation, of engineering and of accounting which may well lead one to ask whether the matter could not better be dealt with by some special allowance or by a change in the rates applicable to income from natural resources.

The taxation of capital gains is probably more sound in theory than the other rule which has been followed so long by England. If the plan is unsound, it must, we think, be unsound because in practice it does not yield satisfactory results, and before accepting this point of view the students of the subject will want to study the defects and if possible cure them by less drastic action than would be involved in a reversal of policy. One other form of tax seems to merit more discussion than has yet been given to it. Last year Representative Mills of New York introduced in congress a bill providing for a tax on spendings. Probably the need for revenue could not be met entirely by a spendings tax alone, and it would have to be coupled for the time being at least with an income tax. Having regard to the vast and growing bulk of tax-free income and the delay that must be encountered in securing a constitutional amendment permitting the taxation of income from future issues of state and municipal securities, the situation is most unsatisfactory and a spendings tax offers a means of at once imposing a tax which will to some extent be levied upon the persons who now enjoy tax-exempt income.

Accountants ought to lead in the discussion of these tax problems and *THE JOURNAL* will welcome thoughtful contributions upon the subject.

American Institute of Accountants

ANNUAL MEETING AT CHICAGO, ILLINOIS,
SEPTEMBER 19 AND 20, 1922

The regular annual meeting of the American Institute of Accountants was held at the Drake Hotel, Chicago, Illinois, September 19 and 20, 1922.

The first session was opened by invocation by the Reverend Albert J. McCartney, D.D.

Minutes of the preceding meeting were approved.

Reports of the president, auditors and council were received.

The meeting approved the action of the council in ratifying an agreement with the American Institute of Accountants Foundation, a new organization created to administer the endowment fund of the Institute.

Upon motion a new rule of conduct which had been adopted by the council was approved. The rule follows:

"No member or associate of the Institute shall advertise his or her professional attainments or services through the mails, in the public prints, or by other written word; but any member or associate may cause to be published in the public prints or otherwise, what is technically known as a 'card.' A card is hereby defined as an advertisement of the name, title (member of American Institute of Accountants, C. P. A., or other professional affiliation or designation), and address of the advertiser without further qualifying words or letters; or in the case of announcements of change of address or personnel of firm the plain statement of the fact for the publication of which the announcement purports to be made. Cards permitted by this rule when appearing in newspapers shall not exceed two columns in width and three inches in depth; when appearing in magazines, directories, and similar publications, cards shall not exceed one quarter page in size. This rule shall not be construed to inhibit the proper and professional dissemination of impersonal information among a member's own clients or personal associates, or the properly restricted circulation of firm bulletins containing staff personnel and professional information."

A paper by Robert H. Montgomery entitled, *Why Should We Have a New Federal Tax Law** was read.

At the opening of the afternoon session of September 19th a paper entitled *Reserves*† was read by H. A. Finney and followed by discussion.

After consideration of the report of the committee on professional advancement several subscriptions to the publicity fund were made and it was resolved that further development of a plan of publicity should be referred to the incoming council.

At the morning session of September 20th several amendments to the constitution and by-laws were considered. Those which were approved are as follows:

The constitution, article III, to be amended by inserting after section 4 a new section as follows:

"Section 5. In the event of a vacancy or vacancies occurring in the membership of council between meetings of the Institute the coun-

*This paper is published elsewhere in this issue of THE JOURNAL OF ACCOUNTANCY.
†See THE JOURNAL OF ACCOUNTANCY, October, 1922.

cil shall be empowered to elect a member or members of the Institute to fill, until the next annual meeting, the vacancy or vacancies so occurring. Such election may take place at any regular or special meeting of the council, or in lieu of a meeting nominations may be called for by the president and the names of the nominees may be submitted to the membership of council for election by mail ballot. A majority vote of the council shall elect."

The constitution, article IV, section 1, to be amended by adding at the close of the section two new paragraphs to read as follows:

"The committee on nominations shall consist of seven members in practice. At the meeting of the council held on the Monday preceding the annual meeting of the Institute or any adjournment thereof the council shall elect from among its number, other than officers or those whose terms expire within one year, two members of the council to serve on the committee on nominations. At the annual meeting of the Institute the members present shall elect from among the members in practice five members of the committee on nominations, other than officers or members of the council. This committee shall make nominations for officers and members of the council. Such committee shall serve for a period of one year and until its successors are elected and qualify, and shall make such nominations as shall be required at least sixty days prior to the annual meeting for the following year. Such nominations shall be sent to the members at least thirty days prior to the annual meeting.

"Any ten members of the Institute may submit independent nominations provided that such nominations be filed with the secretary at least twenty days prior to the annual meeting, such independent nominations to be sent to the membership at least ten days prior to the annual meeting. Nominations for officers and members of the council may be made from the floor at the time of the annual meeting only by the consent of the majority of the members present in person."

The constitution, article V, section 2, to be amended to read as follows:

"Section 2. The board of examiners shall hold examinations annually or, if deemed expedient, semi-annually for candidates. Such examinations shall be oral or written or partly oral and partly written, and by this or such other methods as may be adopted the board of examiners shall determine the technical qualifications and the preliminary education and training of all applicants for membership before applications are submitted to the council. The examinations shall be held simultaneously in different parts of the country at such places as may be determined by the board of examiners where applicants for admittance may conveniently attend."

The constitution to be amended by inserting the following to be numbered article V:

ARTICLE V.

"Upon application to the council of the Institute and subject to its approval there may be organized in any state, by members resident or having a place of business therein, a subsidiary body to be known as a chapter of the American Institute of Accountants under such rules and regulations as the council of the Institute may prescribe."

The present article V to be numbered article VI, and the present article VI to be numbered article VII.

The constitution, article VI, to be amended by deleting sections 1 and 2 and substituting therefor:

"Amendments to the constitution or by-laws of the Institute shall be made only at the annual meeting thereof, and by a two-thirds

Annual Meeting

vote of the members present, but before becoming effective shall be submitted for a mail vote to the entire membership of the Institute, and when approved in writing by a majority thereof shall be declared by the president to be effective. All propositions to amend prepared by the committee on constitution and by-laws shall be embodied in the call for the meeting at which such amendments are to be submitted. It shall be compulsory for the secretary to embody in the call for the annual meeting any other propositions to amend of which he shall have had notice endorsed in writing by thirty or more members in good standing at least sixty days prior to the annual meeting."

The by-laws, article I, section 2, to be amended to read as follows:

"Section 2. The accounts of the Institute shall be audited by two auditors elected at the annual meeting, who shall report at the next annual meeting. The books and accounts shall be submitted by the treasurer for audit at least one week preceding the date of the annual meeting."

The by-laws, article I, section 4, to be amended to read as follows:

"The council may, in its discretion, delegate to the executive committee all functions of the council except election of officers and members, the right to review the rules and regulations of the board of examiners, discipline of members, filling a vacancy in the executive committee and the adoption or alteration of a budget."

The by-laws, article I, section 6, to be amended to read as follows:

"Section 6. The office of a member of the council shall be rendered vacant by his absence from four consecutive meetings of the council."

The by-laws, article II, section 2, to be amended to read as follows:

"Section 2. Any member of the Institute may be represented at regular and special meetings of the Institute by another member acting as his proxy, provided, however:

"(a) that no person shall act as a proxy for more than five members;

"(b) that no proxy given shall confer power of substitution and that all proxies shall become null and void with the final adjournment of the meetings for which they were given."

These amendments have been submitted to the membership of the Institute for referendum ballot and must receive an affirmative vote of the majority of the voting membership before becoming effective.

The following were elected officers and members of council for the ensuing year:

President: Edward E. Gore
Vice-presidents: John R. Loomis, Norman McLaren
Treasurer: Arthur W. Teele

Council for five years:

Elmer L. Hatter
J. Edward Masters
James S. Matteson
Robert H. Montgomery
Carl H. Nau
John B. Niven
E. G. Shorrock

Council for four years:

Clifford E. Iszard

Council for three years:

Charles R. Whitworth

Council for two years:

George S. Olive

Charles E. Mather

C. E. Wermuth

Council for one year:

P. L. Billings

At the afternoon session on September 20th a paper entitled *Treatment of Foreign Exchange in Branch-office Accounting** by Cecil S. Ashdown, and a paper entitled *Taxation of Capital Gains†* by George O. May were read and followed by discussions.

Votes of thanks to the committee on meetings, to the Illinois Society of Certified Public Accountants and to the authors of papers were unanimously adopted.

A motion expressing the appreciation of the Institute of the services rendered by Elijah W. Sells during his tenure of office as a member of council and of committees was adopted following announcement of Mr. Sell's resignation from committee activities.

The annual banquet was held at the Drake Hotel on September 20th. The toastmaster, William M. Lybrand, introduced the following speakers: Captain Imbray, General H. M. Lord, director of the bureau of the budget, J. Adam Bede and President Edward E. Gore.

*See THE JOURNAL OF ACCOUNTANCY, October, 1922.

†This paper is published elsewhere in this issue of THE JOURNAL OF ACCOUNTANCY.

Income-tax Department

EDITED BY STEPHEN G. RUSK

An interesting problem confronted by the solicitor and disposed of by him, as set forth in solicitor's opinion 144, is published in this month's issue. A corporation declared a stock dividend of an amount equalling its accumulation of profits from February 28, 1913, to the date of the issuance of the dividend. It then declared and paid a cash dividend out of its earnings accumulated prior to February 28, 1913. The manner in which the solicitor arrived at the conclusion that "the cash dividend constitutes a taxable distribution under section 201 of the revenue act of 1918" is most interesting. It is difficult for the lay mind to follow the solicitor's reasoning and it may be that his position would not be sustained were the question taken to the courts for adjudication.

The attorney general has given an opinion on "the basis of determining taxable gain and deductible loss in case of property acquired prior to March 1, 1913, and sold or disposed of subsequent thereto." To those who wish to be informed on the latest ruling on this subject we commend the reading of treasury decision 3393 published herein.

Section 231 of the revenue act of 1918 exempts certain organizations from taxation. Paragraph 10 of that section reads as follows:

"Farmers' or other mutual hail, cyclone or fire insurance companies * * * of a purely local character the income of which consists solely of assessments, due and fees collected from members for the sole purpose of meeting expenses."

The kind of an organization thus described is exempt from taxation. A corporation which according to its description by the board of appeals and review is a

"reciprocal indemnity exchange through which certain individuals, firms and corporations conduct a limited insurance on the reciprocal or inter-insurance plan, through an attorney in fact, the O Company, having power to issue policies, collect premiums and adjust losses; it further appears that each subscriber acts individually and deposits a fixed amount to pay losses; that such deposit is held by the attorney in fact and is kept in a separate account in the name of the depositor and at the end of the period for which the insurance runs, any balance of the amount so deposited goes to the depositor"

claims exemption under the provisions of sections 231 (10) quoted above, but was denied such exemption.

Read the recommendation of the board of appeals and review and learn how narrow a line can be drawn between that which must and must not be present for such a corporation to be ruled exempt. This company deposited amounts in advance of the "assessment" and to take care of the expenses and losses when accrued and were incurred. A solicitor's opinion rendered prior to the consideration of this case had defined "assessment" as implying "a payment in which the policyholder has no further right or claim. In other words the essence of an assessment is that the amount thereof is dedicated to the payment of losses or expenses incurred or to be incurred with no right on the part of the person paying the same to a refund of any portion thereof, while a premium deposit contemplates a return or the right to a return to the

policyholder of the part of the amount deposited not needed for the payment of losses, etc."

Verily, the processes of the legal mind are difficult to comprehend.

TREASURY RULINGS

(T. D. 3393, September 12, 1922.)

Income tax—Opinion of the Attorney General.

Basis for determining taxable gain or deductible loss in the case of property acquired prior to March 1, 1913, and sold or disposed of subsequent thereto.

Where property acquired prior to March 1, 1913, is sold or disposed of thereafter—

1. A taxable gain is realized if the selling price is greater than the value on March 1, 1913, and if that value is greater than the cost thereof, to the extent that the selling price exceeds the value on March 1, 1913.

2. A taxable gain is realized if the selling price is greater than the cost and if the cost is greater than the value on March 1, 1913, to the extent that the selling price exceeds the cost of the property sold or disposed of.

3. No taxable gain or deductible loss results if the selling price is greater than the value of the property on March 1, 1913, but less than the cost thereof.

4. A deductible loss results if the selling price is less than the value on March 1, 1913, and if that value is less than the cost, to the extent of the difference between the value on March 1, 1913, and the selling price.

5. No taxable gain or deductible loss results if the selling price is less than the value on March 1, 1913, but greater than the cost.

6. A deductible loss results if the selling price is less than the cost and if the cost is less than the value on March 1, 1913, to the extent that the cost of the property disposed of exceeds the selling price thereof.

The following opinion rendered by the attorney general under date of August 23, 1922, respecting the basis to be used for determining taxable gain or deductible loss in the case of property acquired prior to March 1, 1913, and sold or disposed of subsequent thereto is published in full for your information and guidance:

DEPARTMENT OF JUSTICE,

Washington, August 23, 1922.

SIR: I have the honor to acknowledge receipt of your letter of June 26, 1922, in which you request my opinion as to the proper basis to be used, under the revenue acts of 1916, 1917, and 1918, in computing the taxable gain or deductible loss in the case where property, acquired prior to March 1, 1913, is sold or disposed of thereafter. Accompanying your letter was a brief submitted by the M company, in which the validity of the regulations of the internal revenue and the procedure thereunder are questioned by the company specifically as to the following cases:

Where property acquired prior to March 1, 1913, is sold subsequent thereto at a price which is—

(a) Greater than the value thereof on March 1, 1913, which was higher than cost, or

(b) Greater than the cost thereof, which was higher than the value on March 1, 1913, or

(c) Greater than the value thereof on March 1, 1913, but less than cost, or

(d) Less than the value thereof on March 1, 1913, which was less than cost, or

(e) Less than the value thereof on March 1, 1913, but greater than cost, or

(f) Less than the cost thereof, which was less than the value on March 1, 1913.

The provisions of the revenue act of 1916 material to the subject under consideration, and not changed in any way by the act of 1917, are:

SEC. 2. (a) That, subject to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income derived from * * * businesses, trade, commerce, or sales, or dealings in property whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever;

* * * * *

(c) For the purpose of ascertaining the gain derived from the sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such gain derived.

SEC. 5. * * *

(a) For the purpose of the tax there shall be allowed as deductions—
Fourth. Losses actually sustained during the year, incurred in his business or trade. * * *; *Provided*, That for the purpose of ascertaining the loss sustained from the sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such loss sustained;

Fifth. In transactions entered into for profit but not connected with his business or trade, the losses actually sustained therein during the year to an amount not exceeding the profits arising therefrom;

* * * * *

SEC. 10 * * * For the purpose of ascertaining the gain derived or loss sustained from the sale or other disposition by a corporation, joint-stock company or association, or insurance company, of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such gain derived or loss sustained.

The act of 1918, dealing with the questions propounded, are:

SEC. 202. (a) That for the purpose of ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal, or mixed, the basis shall be—

(1) In the case of property acquired before March 1, 1913, the fair market price or value of such property as of that date; and

(2) In the case of property acquired on or after that date, the cost thereof; or the inventory value, if the inventory is made in accordance with section 203.

SEC. 213. That for the purpose of this title * * * the term "gross income"—

(a) Includes gains, profits, and income derived from * * * trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transactions of any business carried on for gain or profit, or gains or profits and income derived from any source whatever * * *.

T. D. 3206 reads in part as follows:

Regulations No. 45 (1920 edition) are hereby amended in order that the rule announced by the supreme court in the cases of *Goodrich v.*

Edwards and Brewster v. Walsh, respecting the basis for the determination of taxable gain or deductible loss in the case of property acquired prior to March 1, 1913, and sold or disposed of subsequent thereto, may be incorporated therein. * * *

ART. 1561. *Basis for determining gain or loss from sale.*—For the purpose of ascertaining the gain or loss from the sale or exchange of property the basis is the cost of such property, or if acquired on or after March 1, 1913, its cost or its approved inventory value. But in the case of property acquired before March 1, 1913, when its fair market value as of that date is in excess of its cost, the gain which is taxable is the excess of the amount realized therefor over such fair market value. Also in the case of property acquired before March 1, 1913, when its fair market value as of that date is lower than its cost, the deductible loss is the excess of such fair market value over the amount realized therefor. No gain or loss is recognized in the case of property sold or exchanged (a) at more than most but at less than its fair market value as of March 1, 1913, or (b) at less than cost but at more than its fair market value as of March 1, 1913 * * *.

In the case of *Goodrich v. Edwards* (255 U. S. 527) the question of what constituted gain within the meaning of the revenue act of 1916 was passed upon by the United States supreme court, which adopted a concession made by the solicitor general to the effect that where no gain was realized by the taxpayer on a complete transaction, notwithstanding that the selling price was higher than the value on March 1, 1913, no tax should have been assessed against him; holding that section 2 (c) was applicable only where a gain over the original capital investment had been realized after March 1, 1913, from a sale or other disposition of property, establishing the rule that increases in value occurring prior to March 1, 1913, should be excluded in computing taxable gain, and that only increases occurring subsequent to such date should be taxed.

Taxable gain having been thus construed by the Supreme Court, it follows that "deductible loss" should have the same construction, the provisions relating to losses being practically identical with those relating to gain. In making the concession as to taxable gains, the solicitor general, in his brief in the *Goodrich* cases cited above made the further concession that a loss on the complete transaction must have been sustained in order to make it a deductible loss, and that only the loss occurring subsequent to March 1, 1913, should be allowed as a deduction.

The provisions of the revenue act of 1913 which deal with the subject of taxable gains and deductible losses are:

SEC. 202 (a) That for the purpose of ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal, or mixed, the basis shall be—

(1) In the case of property acquired before March 1, 1913, the fair market price or value of such property as of that date; and

(2) In the case of property acquired on or after that date, the cost thereof; or the inventory value, if the inventory is made in accordance with section 203.

SEC. 213. That for the purpose of this title * * * the term "gross income"—

(a) Includes gains, profits, and income derived from * * * trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

No substantial changes having been made in the corresponding sections of the two acts, it is assumed that both acts were intended by congress to have the same construction, and the same basis should be

employed in arriving at taxable gains and deductible losses upon the sale or other disposition of property.

I am of the opinion that the date March 1, 1913, was intended to be used as a guide in ascertaining gains derived or losses sustained, but that the original cost should be taken into consideration, so that if there was no gain on the entire transaction there was no taxable gain, and if there was no loss on the entire transaction there was no deductible loss. It follows, therefore, that in limiting the M company to the loss sustained by it on the sale of shares of stock of the O company; that is, the difference between cost and selling price, instead of to the difference between March 1, 1913, value and selling price, the internal revenue bureau acted in accordance with law. In other words, the basis to be employed, under the acts of 1916, 1917, and 1918, for the purpose of ascertaining the gain or loss from the sale or other disposition of property is the cost; and that in the case of property acquired prior to March 1, 1913, when its fair market value as of that date is in excess of its cost, the taxable gain is the excess of the amount realized over such fair market value; that when its fair market value as of March 1, 1913, is lower than its cost, the deductible loss is the excess of such fair market value over the amount realized therefor; and that when the property is sold or otherwise disposed of at more than cost but at less than March 1, 1913, value, or at less than cost but at more than March 1, 1913, value, neither taxable gain nor deductible loss results.

Replying specifically to the inquiry, I am of the opinion that where property acquired prior to March 1, 1913, is sold or disposed of thereafter—

(a) Taxable gain resulted if the selling price was higher than the value on March 1, 1913, and if that value was higher than the cost, thereof, to the extent that the selling price exceeded the value on March 1, 1913;

(b) Taxable gain resulted if the selling price was greater than the cost and if the cost was greater than the value on March 1, 1913, to the extent that the selling price exceeded the cost of the property sold or disposed of;

(c) No taxable gain or allowable loss resulted if the selling price was greater than the value of the property on March 1, 1913, but less than the cost thereof;

(d) An allowable loss resulted if the selling price was less than the value on March 1, 1913, and if that value was less than the cost to the extent of the difference between the value on March 1, 1913, and the selling price;

(e) No taxable gain or deductible loss resulted if the selling price was less than the value thereof on March 1, 1913, but greater than the cost; or

(f) An allowable loss resulted if the selling price was less than the cost and if the cost was less than the value on March 1, 1913, to the extent that the cost of the property disposed of exceeded the selling price thereof.

Respectfully,

H. M. DAUGHERTY, *Attorney General.*

The honorable the SECRETARY OF THE TREASURY.

RULINGS MADE PUBLIC SINCE BULLETIN I—39.

SECTION 201, ARTICLE 1541: Dividends.

DIVIDENDS: SECTION 201, REVENUE ACT OF 1918.

When a corporation declares, subsequent to January 1, 1918, a stock dividend equal in amount to the earnings and profits accumu-

lated since February 28, 1913, and then declares a cash dividend, such cash dividend constitutes a taxable distribution under section 201 of the revenue act of 1918.

A stock dividend equal in amount to the earnings and profits accumulated between the close of the preceding taxable year and the date of issuance does not make unavailable for subsequent distribution after the first 60 days of a taxable year the earnings and profits accumulated between the close of the preceding taxable year and the date of distribution.

My opinion has been requested as to whether a stock dividend constitutes a distribution of earnings and profits under section 201 of the revenue act of 1918. The issue arises in connection with two questions: (1) Whether a cash dividend distributed subsequent to the issuance of a stock dividend equal in amount to the earnings and profits accumulated since February 28, 1913, is a distribution from earnings and profits accumulated prior to March 1, 1913; and (2) whether a cash dividend distributed after the first 60 days of a taxable year, and subsequent to a stock dividend which is equal in amount to the earnings and profits accumulated between the close of the preceding taxable year and the date of issuance, distributes the earnings and profits accumulated between the close of the preceding taxable year and the date of issuance or the earnings and profits accumulated during the preceding taxable years.

Section 201 of the revenue act of 1918 provides as follows:

(a) That the term "dividend" when used in this title (except in paragraph (10) of subdivision (a) of section 234) means (1) any distribution made by a corporation, other than a personal service corporation, to its shareholders or members, whether in cash or in other property or in stock of the corporation, out of its earnings or profits accumulated since February 28, 1913, or (2) any such distribution made by a personal service corporation out of its earnings or profits accumulated since February 28, 1913, and prior to January 1, 1918.

(b) Any distribution shall be deemed to have been made from earnings or profits unless all earnings and profits have first been distributed. Any distribution made in the year 1918 or any year thereafter shall be deemed to have been made from earnings or profits accumulated since February 28, 1913, or in the case of a personal service corporation, from the most recently accumulated earnings or profits; but any earnings or profits accumulated prior to March 1, 1913, may be distributed in stock dividends or otherwise, exempt from the tax, after the earnings and profits accumulated since February 28, 1913, have been distributed.

(c) A dividend paid in stock of the corporation shall be considered income to the amount of the earnings or profits distributed. Amounts distributed in the liquidation of a corporation shall be treated as payments in exchange for stock or shares, and any gain or profit realized thereby shall be taxed to the distributee as other gains or profits.

(d) If any stock dividend (1) is received by a taxpayer between January 1 and November 1, 1918, both dates inclusive, or (2) is during such period bona fide authorized or declared, and entered on the books of the corporation, and is received by a taxpayer after November 1, 1918, and before the expiration of 30 days after passage of this act, then such dividend shall, in the manner provided in section 206, be taxed to the recipient at the rates prescribed by law for the years in which the corporation accumulated the earnings or profits from which such dividend was paid, but the dividend shall be deemed to have been paid from the most recently accumulated earnings or profits.

(e) Any distribution made during the first 60 days of any taxable year shall be deemed to have been made from earnings or profits accumulated during preceding taxable years; but any distribution made during the remainder of the taxable year shall be deemed to have been made

from earnings or profits accumulated between the close of the preceding taxable year and the date of distribution, to the extent of such earnings or profits, and if the books of the corporation do not show the amount of such earnings or profits, the earnings or profits for the accounting period within which the distribution was made shall be deemed to have been accumulated ratably during such period.

Is a stock dividend a distribution within the meaning of the above section? It will be noted that subdivision (a) of section 201 defines *dividends* as a distribution in cash, property, or stock of the corporation to its shareholders or members out of earnings or profits accumulated since February 28, 1913, except in the case of personal service corporations. This subdivision is premised upon the proposition that a stock dividend is a taxable distribution. On the assumption that it is such a distribution, there is included within the definition of a dividend a stock dividend. Congress does not define a stock dividend as a distribution but, on the other hand, treats a distribution in stock as a dividend for the purposes of the act. This is made clear by a realization that subdivision (a) was inserted in the act not for the purpose of determining from a corporate standpoint how a distribution should be allocated but rather to define a term used in other sections of the act which make the receipt of the thing defined income. In other words, section 201 (a) does not affect the corporation, but points out to a stockholder when he receives taxable income.

Subdivision (b) of section 201 contains the presumption that distributions shall be deemed to have been made from earnings and profits unless they have all been distributed, and further that any distributions made in the year 1918, or thereafter, are made from earnings or profits accumulated since February 28, 1913 (except in the case of a personal service corporation). It then provides that earnings or profits accumulated prior to March 1, 1913, may be distributed in stock dividends or otherwise exempt from tax after the earnings and profits accumulated since February 28, 1913, have been distributed. The latter part of this subdivision is predicated upon the assumption by congress that a stock dividend is a distribution; but whether or not it constitutes a distribution, it is stated that a stock dividend out of earnings and profits accumulated prior to March 1, 1913, is not taxable. In other words, this subdivision does not define a stock dividend as a distribution because it is immaterial for its purposes whether or not a stock dividend constitutes a distribution.

Subdivisions (c) and (d) describe the amount of income and the rates at which such income is to be taxed in the case of a stock dividend. They do not impose a tax on a stock dividend, but only prescribe the effect of a stock dividend for taxing purposes.

A stock dividend, therefore, is not defined as a distribution by section 201 of the revenue act of 1918. Furthermore, section 201 does not include *any distribution*, but only a distribution of earnings and profits. Subdivision (a) provides that the term "dividend" means any distribution, "whether in cash or in other property or in stock of the corporation, out of its earnings or profits accumulated since February 28, 1913." If a stock dividend is not a distribution of earnings and profits, it does not come within its meaning.

The supreme court has not only held that a stock dividend is not income to a stockholder, but has also stated that nothing is distributed by the payment of such a dividend. In the case of *Towne v. Eisner* (245 U. S. 418) the court, quoting *Gibbons v. Mahon* (136 U. S., 549), said (p. 203):

A stock dividend really takes nothing from the property of the corporation, and adds nothing to the interests of the shareholders. Its property is not diminished, and their interests are not increased. And held that a stock dividend was not income under the revenue act of 1913.

By section 2 (a) of the revenue act of 1916, dividends were defined to mean any distribution "made or ordered to be made by a corporation * * * out of its earnings or profits accrued since March 1, 1913, and payable to its shareholders, whether in cash or in stock of the corporation * * * which stock dividend shall be considered income to the amount of its cash value." In the case of *Eisner v. Macomber* (252 U. S., 189) (C. B. 3, p. 25), it was held that a stock dividend declared in January, 1916, did not constitute taxable income to a stockholder. In reaching its conclusion, the court declares that a stock dividend—

* * * is no more than a book adjustment, in essence not a dividend, but rather the opposite; no part of the assets of the company is *separated* from the common fund, nothing *distributed* except paper certificates that evidence an antecedent increase in the value of the stockholder's capital interest resulting from an accumulation of profits by the company, but profits so far absorbed in the business as to render it impracticable to separate them for withdrawal and distribution. (P. 194.)

Again the court says:

A "stock dividend" shows that the company's accumulated profits have been capitalized instead of *distributed* to the stockholders or retained as surplus available for distribution in money or in kind should opportunity offer. Far from being a realization of profits of the stockholders, it tends rather to postpone such realization, in that the fund represented by the new stock has been transferred from surplus to capital, and no longer is available for *actual distribution*. (P. 194.)

On page 195 the court answers the government's contention that a stock dividend constitutes a distribution as follows:

* * * the government contends that the tax "is levied on income derived from corporate earnings," when in truth the stockholder has "derived" nothing except paper certificates, which, so far as they have any effect, deny him present participation in such earnings. It contends that the tax may be laid when earnings "are received by the stockholder," whereas he has received none; that the profits are "distributed by means of a stock dividend," although a *stock dividend distributes no profits*; that under the act of 1916 "the tax is on the stockholder's share in corporate earnings," when in truth a stockholder has no such share, and receives none in a stock dividend; that "the profits are segregated from his former capital, and he has a separate certificate representing his invested profits or gains," whereas *there has been no segregation of profits*, nor has he any separate certificate representing a personal gain, since the certificates, new and old, are alike in what they represent—a capital interest in the entire concerns of the corporation." (P. 195.)

The above quotations, and especially the italicized parts, conclusively answer any argument to the effect that there is a distribution of earnings and profits by a stock dividend. When the court held that the receipt of a stock dividend was not the receipt of income by a stockholder, it necessarily held that there was no division among stockholders of earnings and profits, according to a former decision in *M. & O. R. R. v. Tennessee* (153 U. S., 486, 496), where a distribution was defined to mean "that portion of its profits which the corporation, by its directory, sets apart for ratable division among its shareholders."

Congress has provided in section 201 (b) of the revenue act of 1918 that any distribution made in the year 1918, or any year thereafter, is made from earnings or profits accumulated since February 28, 1913. (S. O. 140, Bulletin I—19—263, p. 7.) Consequently, if a stock dividend does not constitute a distribution of earnings and profits, any cash dividend declared must be from any earnings or profits accumulated subsequent to February 28, 1913, when the corporation has on hand earnings and profits accumulated prior to March 1, 1913. Also subdivision (e) of section 201 provides that any distribution made after the first 60 days of a taxable year is made from earnings and profits accumulated between the close of the preceding taxable year and the date of the distribution

to the extent of such earnings and profits. In other words, irrespective of whether or not a stock dividend capitalizes earnings and profits, the fact remains that such earnings and profits have not been distributed, and, therefore, a cash dividend is from those earnings and profits.

Even though it may be argued that in view of the opinion of the supreme court in the case of *Eisner v. Macomber* a stock dividend makes earnings and profits unavailable for distribution, nevertheless it can not be maintained that a stock dividend capitalizes the latest earnings and profits because a corporate resolution attempts to allocate such a dividend to subsequently accumulated earnings. This follows from the fact that the presumption that a cash dividend is declared out of the latest earnings and profits is a statutory one, and has been held to be conclusive (S. O. 140), and also because a corporation is unable to earmark or fix as capital or capital stock any particular earnings. (*Canal & Banking Co. v. Moran*, 99 U. S., 99; *Anderson v. Farmers' Loan & Trust Co.*, 241 Fed., 328.)

In view of the above, it is clear that a stock dividend does not constitute a distribution of earnings and profits within the meaning of section 201 of the revenue act of 1918.

Therefore, in my opinion, (1) when a corporation declares, subsequent to January 1, 1918, a stock dividend equal in amount to the earnings and profits accumulated since February 28, 1913, and then declares a cash dividend, such cash dividend constitutes a taxable distribution under section 201 of the revenue act of 1918; and (2) a stock dividend equal in amount to the earnings and profits accumulated between the close of the preceding taxable year and the date of issuance does not make unavailable for subsequent distribution after the first 60 days of a taxable year the earnings and profits accumulated between the close of the preceding taxable year and the date of distribution.

SECTION 204, ARTICLE 1601: Net loss, definition and computation.

SECTION 204—REVENUE ACT OF 1918.

Recommended, in the appeal of the M Company, that the action of the income tax unit in rejecting the said company's claims for refund and abatement of 1918 taxes, filed under the provisions of section 204 of the revenue act of 1918, be sustained.

The committee has had under consideration the appeal of the M Company from the action of the income tax unit in rejecting that company's claims for the refund of x dollars income and profits taxes paid for the calendar year 1918 and the abatement of the balance of such taxes assessed for that year, which claims were filed under the provisions of section 204 of the revenue act of 1918 to cover a net operating loss sustained during the period January 1 to December 31, 1919.

The records show that the net income of the M Company for the calendar year 1918, as adjusted by the income tax unit, amounted to 12.18 x dollars and its total tax liability for the same period to 5.12 x dollars. Subsequent to the filing of the 1918 return the appellant company changed its accounting period from a calendar-year to a fiscal-year basis and the first return filed on this new basis was for the period January 1 to July 31, 1919, which return, as adjusted by the income tax unit, showed a net loss of 11.24 x dollars, and it is claimed that on December 31, 1919, a full inventory was made and a trial balance taken from the books of the appellant company, which showed a net operating loss of 4.52 x dollars for the period August 1 to December 31, 1919; and upon examination by a field officer it was found that for the full fiscal year—August 1, 1919, to July 31, 1920—the appellant company had sustained a net operating loss of 5.01 x dollars.

Accepting the appellant company's statement that a net operating loss of 4.52 x dollars was sustained during the last five months of 1919 as true, it appears that the said company's operations for the two-year

period January 1, 1918, to December 31, 1919, resulted in a net operating loss of 3.58x dollars, computed as follows:

	Dollars.
Net income for calendar year 1918.....	12.18x
Net loss for period Jan. 1 to July 31, 1919.....	11.24x
Net loss for period Aug. 1 to Dec. 31, 1919.....	4.52x
	<u>15.76x</u>
Net loss for two-year period.....	<u>3.58x</u>

And it is the net loss of 15.76x dollars incurred during the period January 1 to December 31, 1919, which the appellant company now seeks to have deducted from the net income for the calendar year 1918 under the provisions of section 204, with the resultant reduction of tax liability for that year.

The corporation in support of its appeal contends that—

* * * it was clearly the intent of congress in section 204 of the act to provide the taxpayer with relief from excessive taxes in the war year 1918, providing it was shown that the profits on which such taxes were based were in reality only paper profits and were dissipated by a return to normal circumstances in the succeeding year. * * *

And it is argued that office decision 445 (C. B. 2, p. 58), the terms of which the income tax unit holds preclude the allowance of the appellant company's claim—

* * * is intended to cover cases where the fraction of year under which allowance is claimed shows a loss and the fraction necessary to complete a full year shows a profit, the full year showing a profit or at least a smaller loss than the fractional year. * * *

And that—

If O. D. 445 is intended to cover cases other than that outlined above, then it is respectfully contended that it is clearly not in accord with the intent of congress as shown in section 204 of the act.

That part of section 204 of the revenue act of 1918 which may be deemed pertinent to the question here at issue reads as follows:

(b) If for any taxable year beginning after October 31, 1918, and ending prior to January 1, 1920, it appears upon the production of evidence satisfactory to the commissioner that any taxpayer has sustained a net loss, the amount of such net loss shall under regulations prescribed by the commissioner with the approval of the secretary be deducted from the net income of the taxpayer for the preceding taxable year; and the taxes imposed by this title and by Title III for such preceding taxable year shall be redetermined accordingly. Any amount found to be due to the taxpayer upon the basis of such redetermination shall be credited or refunded to the taxpayer in accordance with the provisions of section 252. If such net loss is in excess of the net income for such preceding taxable year, the amount of such excess shall under regulations prescribed by the commissioner with the approval of the secretary be allowed as a deduction in computing the net income for the succeeding taxable year.

Section 200 of the revenue act of 1918 provides that—

The term "taxable year" means the calendar year, or the fiscal year ending during such calendar year, upon the basis of which the net income is computed under section 212 or section 232. The term "fiscal year" means an accounting period of 12 months ending on the last day of any month other than December. The first taxable year, to be called the taxable year 1918, shall be the calendar year 1918 or any fiscal year ending during the calendar year 1918.

In the instant case neither the net loss of 11.24x dollars sustained during the period January 1 to July 31, 1919, nor the loss of 4.52x dollars sustained during the period August 1 to December 31, 1919, is a loss

for a full taxable year, and, therefore, neither loss is deductible under the provisions of section 204 from the net income of the calendar year 1918, it having been held in O. D. 445 that—

If a taxpayer changes his accounting period in such manner that the period from the close of his previous taxable year to the close of his newly established taxable year falls between October 31, 1918, and January 1, 1920, and he sustains a net loss during such fractional year period, he is not entitled to the relief provided by section 204 of the revenue act of 1918, since the net loss sustained is not for a full taxable year as provided by the act.

In the determination of income tax liability under the provisions of the 1918 act net income or net loss must be computed with respect to a fixed period, and, therefore, the net loss sustained in the instant case during the taxable period January 1 to July 31, 1919, can not be consolidated with the net loss for the period August 1 to December 31, 1919, and the net result thus obtained deducted, under the provisions of section 204, from the appellant company's net income for the calendar year 1918.

In view of the foregoing, the committee recommends that the action of the income tax unit in rejecting the M Company's said claims for refund and abatement be sustained.

SECTION 231, ARTICLE 521: Local mutual insurance companies and like organizations.

REVENUE ACT OF 1916—SECTION 11 (a) (TENTH); REVENUE ACT OF 1918—SECTION 231 (10); REVENUE ACT OF 1921—SECTION 231 (10).

Recommended, in the appeal of the M Association, that the action of the income tax unit in denying the taxpayer exemption from taxation under the provisions of section 11 (a) (tenth) of the revenue act of 1916, as amended, and section 231 (10) of the revenue acts of 1918 and 1921 be sustained.

The committee has had under consideration the appeal of the M Association from the action of the income tax unit in denying the organization classification as one which derives its income solely from assessments, dues and fees, and accordingly is exempt from taxation under the provisions of section 11 (a) (tenth), revenue act of 1916, as amended, and section 231 (10) of the revenue acts of 1918 and 1921.

It appears from the record that the M Association, originally the N Association, was organized under the laws of the state of Y, in 1916, without capital stock. The appellant corporation is a reciprocal indemnity exchange, through which certain individuals, firms, and corporations conduct a limited insurance on the reciprocal or interinsurance plan, through an attorney in fact, the O Company, having power to issue policies, collect premiums, and adjust losses. It further appears that each subscriber acts individually and deposits a fixed amount to pay losses; that such deposit is held by the attorney in fact and is kept in a separate account in the name of the depositor, and at the end of the period for which the insurance runs, any balance of the amount so deposited goes to the depositor. It is also shown that the funds are deposited in the banks or invested in securities approved by the board of trustees, of which there are five in number, and that all disbursements of funds are made by the attorney in fact with the approval of the board of trustees.

The corporation has had but one office during all the time of its operation, and up to September —, 1920, operated in one community. During June, July, and August, 1918, — policies were written from the Y office on the automobiles of persons residing in another state. For the year ending December 31, 1917, the appellant company had no receipts. The attorney in fact advanced money to the association to pay its losses and expenses, and at the end of the year 1917 the

association had a deficit of 1.52x dollars, representing the combined amount of the losses and expenses for that year. During the year ending December 31, 1918, the association had total receipts of 9.63x dollars, paid losses in the amount of 2.65x dollars, and expenses of adjustment, etc., in the amount of 1.03x dollars, or a total expenditure of 3.68x dollars. During the year ending December 31, 1919, the total receipts of the association amounted to 14.23x dollars, of which the sum of .2x dollars represented interest on bank balances. It paid during this year losses in the amount of 4.26x dollars, expenses of adjustment, etc., in the amount of 1.74x dollars, and taxes in the amount of .12x dollars, or a total expenditure for the year of 6.72x dollars, leaving a balance on hand from the operations for the year 1919 in the amount of 7.51x dollars. This sum added to the balance of 4.42x dollars on hand at the beginning of the year resulted in a bank balance at December 31, 1919, of 11.93x dollars. This amount belonged to the members of the association, and was held for them and placed to their individual credit for the payment of losses or, in the case of dissolution, to be returned to them as credited upon the books.

Upon consideration of the foregoing facts, the income tax unit held that the appellant corporation operates upon the premium deposit plan; does not receive its income solely from assessments, dues, and fees collected from members for the sole purpose of meeting expenses, as provided by statute; and consequently is required to file amended returns of annual net income and pay any taxes due thereon. It is from this action that the taxpayer appeals.

Inasmuch as the question involved appeared to be of a legal character, the case was referred to the solicitor for advice and the expression of an opinion. The committee is in receipt of the solicitor's opinion, which reads as follows:

Reference is made to the case of the M Association, being an appeal from a decision denying the organization classification as one which derived its income solely from assessments, dues, and fees.

The unit held that the corporation was not exempt because it operated on the premium deposit plan and, further, because it is not local in character.

It appears that the corporation operates on the interindemnity plan, requiring deposits from policyholders and acting through an attorney in fact.

It is contended that prior to _____, 1920, the organization operated on the "post-mortem" plan, making assessments at intervals for the purpose of meeting claims that had been passed upon and which were due but not passed. During the year ending December 31, 1918, the association had total receipts of 9.63x dollars and total expenditures of 3.68x dollars. "It therefore had on hand on December 31, 1918, money advanced by the members to the amount of 4.42x dollars, which was on deposit in the bank." The balance on December 31, 1919, was 11.93x dollars. The claim for refund states: "All this money belonged to the members of the association, and was held for them to their individual credit for the payment of losses or, in case of dissolution, to be returned to them as credited upon the books."

The subscribers' agreement submitted indicates that each subscriber bound himself to deposit with the attorney in fact when called for by him a sufficient sum of money to pay his proportion of losses, adjustment expenses, etc. Subscribers' deposits were required to be deposited in banks or invested in securities, and upon notice of cancellation the attorney in fact was required to liquidate the accounts and return the unused deposit.

Article 521 of regulations 45 holds that if an organization receives income from sources such as cash premiums or premium deposits it is not exempt; and the question is presented whether amounts deposited

as above outlined should be regarded as premium deposits or as assessments.

Solicitor's opinion 99 (C. B. 4, p. 270) shows that "assessment" implies a payment in which the policyholder has no further right or claim. In other words, the essence of an assessment is that the amount thereof is dedicated to the payment of losses or expenses incurred or to be incurred with no right on the part of the person paying the same to a refund of any portion thereof, while a premium deposit contemplates a return or the right to a return to the policyholder of the part of the amount deposited not needed for payment of losses, etc. (See S. O. 141; Bulletin I—23—1922.)

The claim here is that the deposits are assessments, but that they belong to the depositors. These claims are inconsistent. If the deposits belong to the subscribers in the sense that they are entitled to a return of any unused portion thereof, they do not fall within the classification of assessments, but do fall within the classification of premium deposits. It seems clear from the foregoing and the general manner in which indemnity exchanges are conducted, that the deposits in the instant case fall in the latter class.

You are accordingly advised that the M Association was not entitled to exemption as a corporation the income of which consists solely of assessments, dues, and fees collected for the sole purpose of meeting expenses while operating as above outlined.

In view of the foregoing opinion of the solicitor, in which the committee finds itself thoroughly in accord, it is recommended in the appeal of the M Association that the action of the income tax unit in denying the taxpayer exemption from taxation under the provisions of section 11 (a) (tenth) of the revenue act of 1916, as amended, and section 231 (10) of the revenue acts of 1918 and 1921 be sustained.

JAMES C. MAHON

James C. Mahon, member of the American Institute of Accountants, died suddenly at Martinsville, Indiana, September 25, 1922.

Mr. Mahon had been prominent in accounting in Kentucky for many years and was president of the Kentucky Institute. The week before his death he had attended the annual meeting of the American Institute of Accountants and seemed to be in perfect health.

The funeral was held at the Fourth Avenue Presbyterian Church, Louisville, Kentucky.

Smith, Brodie & Lunsford and Francis A. Wright & Co. announce that they have combined their practices as of October 1, 1922, and will hereafter practise under the name of Smith, Brodie, Lunsford & Wright, with offices at 816 Lathrop building, Kansas City, Missouri.

Edward A. McAllister and William D. Patterson announce the formation of a partnership under the firm name of E. A. McAllister & Company, with offices at 2 Rector street, New York, and 8 Main street, Yonkers, New York.

Roden & Hart of 909-912 Fourth National Bank building, Cincinnati, Ohio, announce the admission to partnership of H. W. Weiss.

Harry L. Carpenter announces the opening of an office at 1457 Broadway, New York.

Students' Department

EDITED BY H. A. FINNEY

CORRECTION—Page 303 of October issue:—The items \$33,000 a and \$1,800 b, which appear in the credit adjustment column, should be in the debit column, and the total of the debit column should be \$34,800 instead of \$34,000.

Editor, Students' Department:

Sir: May I request that you furnish solutions to the two following problems, which will be much appreciated?

1. The balance-sheet of the A. B. Company, on June 30, 1920, is as follows:

Land, buildings, plant and equipment.....	\$300,000	
Less reserve for depreciation	50,000	\$250,000
Inventories of finished goods and in process.....	400,000	
Inventories of raw materials and manufactured supplies	250,000	650,000
Accounts and bills receivable.....	127,000	
Less reserve for bad debts.....	4,000	123,000
Cash on hand and in bank.....		13,000
Sundry assets		2,000
		<u>\$1,038,000</u>
Capital stock: Preferred	\$200,000	
Common	300,000	\$500,000
Profit and loss.....		213,000
Bank advances (secured)		200,000
Sundry trade creditors and accrued charges.....		75,000
Business profits taxes unpaid		50,000
		<u>\$1,038,000</u>

The preferred stock is preferred as to dividends only, and all dividends on this stock to June 30, 1920, have been paid.

The business is sold as of the date of the balance-sheet to the C. D. Company, on the following terms:

(a) Land, buildings, plant and equipment are taken by the purchasing company at the depreciated book value and preferred stock of the purchasing company is issued at par fully paid in payment thereof.

(b) The C. D. Company takes over the inventory, accounts receivable, bills receivable and sundry assets at 100 cents on the dollar, the reserve for bad debts which had been set up under special circumstances in 1910 not being required, and pays therefor by undertaking to discharge the liabilities shown except the liability for taxes, and as to the balance by paying 25% thereof in cash and 75% by the issue of preference stock at par fully paid up.

Students' Department

(c) The C. D. Company pays \$250,000.00 for the goodwill, by the issue of its preferred stock fully paid of a like amount.

Assuming that the liability for taxes has been correctly estimated, prepare a balance-sheet of the A. B. Company giving effect to the sale, showing the interests of the preferred and common shareholders in the business.

2. The profit-and-loss account of the A. B. Company in the preceding question for the last four years of its continuing in operation has been:

Balance at credit, June 30, 1916.....			\$85,000.00
Profit for year ending June 30, 1917, after deducting taxes and all other charges.....		\$70,000.00	
Less dividends paid:			
Preferred	\$14,000.00		
Common	30,000.00	44,000.00	26,000.00
Profit for year ending June 30, 1918, after deducting taxes and all other charges.....		80,000.00	
Less dividends paid:			
Preferred	\$14,000.00		
Common	30,000.00	44,000.00	36,000.00
Profit for year ending June 30, 1919, after deducting taxes and all other charges.....		80,000.00	
Less dividends paid:			
Preferred	\$14,000.00		
Common	30,000.00	44,000.00	36,000.00
Profit for year ending June 30, 1920, after deducting taxes and all other charges		89,000.00	
Less dividends paid:			
Preferred	\$14,000.00		
Common	45,000.00	59,000.00	30,000.00
Balance at credit June 30, 1920, per balance-sheet...			<u>\$213,000.00</u>

The preferred shareholders of the A. B. Company have accepted fully paid preference stock of the purchasing company at par in settlement of their interest in the company, and their stock has been distributed to them as on June 30, 1920. The taxes have been paid at the figure given and distribution is to be made to the common shareholders before December 31, 1920. Draft circular letter to the common shareholders with statement to accompany it showing how you would make the final distribution to them. Assume that there are no further expenses to be met in winding up and provide whatever cash you consider necessary by the sale at par from the preference stock of the C. D. Company held.

Thanking you in anticipation of having your solutions set out in a subsequent number of The Journal, I am

Yours truly,
J. V. R.

Solution to the first problem:

WORKING PAPERS

SALE OF A. B. COMPANY TO C. D. COMPANY

	Balance-sheet before sale	Dr.	Cr.	Balance-sheet after sale
	Assets	Liabilities		Assets
Land, buildings, plant and equipment.....	\$300,000		\$300,000 A	
Reserve for depreciation		\$50,000		
Inventories—finished goods and in process...	400,000		400,000 B	
Inventories—materials and supplies.....	250,000		250,000 B	
Accounts and bills receivable.....	127,000		127,000 B	
Reserve for bad debts.....		4,000		
Cash	13,000		4,000 C	
Sundry assets	2,000		126,000 B	\$139,000
Capital stock—preferred		200,000		\$200,000
Capital stock—common		300,000		300,000
Profit and loss		213,000		467,000
Bank advances		200,000	200,000 B	
Trade creditors and accrued charges.....		75,000	75,000 B	
Business profits taxes		50,000		50,000
	<u>\$1,092,000</u>	<u>\$1,092,000</u>		
Preferred stock of C. D. Company:				
For land, buildings, plant and equipment.....		250,000 A		
For 75% of net current assets.....		378,000 B		
For goodwill		250,000 D		
		<u>\$1,333,000</u>	<u>\$1,333,000</u>	<u>878,000</u>
				<u>\$1,017,000</u>

Explanations:

- A. Entry for sale of fixed assets.
- B. Entry for sale of current assets, subject to current liabilities except taxes.
- C. Entry returning reserve for bad debts to profit and loss.
- D. Entry for stock received for goodwill.

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THE A. B. COMPANY BALANCE-SHEET—JUNE 30, 1920 (AFTER SALE)

<i>Assets</i>		
Cash		\$139,000.00
Preferred stock of the C. D. Company.....		878,000.00
		\$1,017,000.00
<i>Liabilities</i>		
Business profits taxes unpaid.....		\$50,000.00
Preferred stockholders' equity:		
Par of stock		200,000.00
Common stockholders' equity:		
Par of stock	\$300,000.00	
Surplus	467,000.00	767,000.00
		\$1,017,000.00

The problem states that the preferred stock is cumulative, but does not state whether it is participating. This information is necessary if a balance-sheet is to show the respective interests of the preferred and common stockholders. The second problem, which is related to this one, shows that while the preferred stock has been paid dividends of 7% each year, the common stock has received 10% dividends for three years and a 15% dividend one year. This shows that the preferred stock is non-participating, and has no interest in the surplus, since its dividends have been paid to the date of the balance-sheet. Therefore the preferred stockholders' equity is shown in the foregoing balance-sheet at the par of the stock.

Solution to Second Problem. The assets to be distributed among common stockholders are computed as follows:

	Cash	Preferred Stock C. D. Co.
Balances per balance-sheet in preceding solution..	\$139,000	\$878,000
Payment of taxes	50,000	
Distribution to holders of A. B. Co. preferred...		200,000
	\$89,000	\$678,000

The cash and preferred stock on hand add to \$767,000.00, the amount of the common stockholders' equity, as shown in the balance-sheet. Assuming that the common stock has a par value of \$100.00 per share, there are 3,000 shares outstanding, and each share has a book value of $\$767,000 \div 3,000$, or $\$255.66\frac{2}{3}$.

The amount of cash necessary to obtain from sales of C. D. Co. preferred stock would depend upon how widely the common stock of the

A. B. Company is distributed, and what is the smallest number of shares held by any one individual. If the stock is held as follows:

X	1,500 shares
Y	750 "
Z	750 "

it is not necessary to sell any of the preferred stock, for the distribution may be made as follows:

	Cash	Stock	Total
X $\frac{1}{2}$	\$44,500	\$339,000	\$383,500
Y $\frac{1}{4}$	22,250	169,500	191,750
Z $\frac{1}{4}$	22,250	169,500	191,750
Total	<u>\$89,000</u>	<u>\$678,000</u>	<u>\$767,000</u>

As an opposite extreme, assume that there are a number of stockholders owning only one share of A. B. common stock. Each should receive preferred stock and cash totaling \$255.67. This could be done by giving each stockholder two shares of stock and \$55.67 in cash for each share of common stock held. If the preferred stock has a speculative value, it would be necessary to maintain this ratio for all stockholders to avoid any possible injustice. To illustrate, assume that R owns one share of A. B. Company common and S owns 100 shares. Then the book value of R's stock is \$255.67 and the book value of S's stock is \$25,566.67. Now assume that the ratio of stock to cash mentioned above, is not maintained, but that stock is given for round hundreds of dollars and cash is given for odd amounts. Then payments would be made as follows:

	R	S
Stock	\$200.00	\$25,500.00
Cash	55.67	66.67
Total	<u>\$255.67</u>	<u>\$25,566.67</u>

Now let us assume that the preferred stock of the C. D. Company proves to have a market value of only 90, and that R and S dispose of their shares, taking a 10 point loss. R would lose \$20.00. S, who had 100 times as large an interest as R in the A. B. Company, should have been settled with in such a manner that he would lose 100 times as much as R; or if the market went the other way, gain 100 times as much. That is, he should have been left where he would have lost only \$20.00 x 100, or \$2,000.00, instead of \$2,556.67. This means that if R receives for each A. B. share two shares of C. D. preferred and the balance in cash, S should be paid in the same ratio, as follows:

	R	S
A. B. stock held—par.	\$100.00	\$10,000.00
C. D. Co. preferred stock received—par..	<u>\$200.00</u>	<u>\$20,000.00</u>
Cash	55.67	5,566.67
Total	<u>\$255.67</u>	<u>\$25,566.67</u>

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Now if the C. D. stock drops ten points, R will lose \$20.00 and S will lose \$2,000.00.

In order to make a distribution on this basis, assuming that there are A. B. stockholders with only one share, cash will be required as follows:

Total book value of A. B. common stock.....	\$767,000.00
Amount to be liquidated in C. D. preferred stock:	
Par of A. B. stock outstanding.....	\$300,000
Multiply by	2
Par of preferred stock to be distributed..	600,000.00
Amount to be distributed in cash	<u>\$167,000.00</u>

This requires sales of preferred stock at par as follows:

	Cash	Preferred Stock
Balances before sale of preferred stock	\$ 89,000.00	\$678,000.00
Sale of preferred stock.....	78,000.00	78,000.00
Balances after sale	<u>\$167,000.00</u>	<u>\$600,000.00</u>

Of course, any stockholder who, by this settlement, would be entitled to receive \$100.00 or more in cash and who preferred to take another share of C. D. stock in place of the \$100.00, should have that option, and the number of shares of preferred stock to be sold would be reduced to the extent that the option was exercised.

CIRCULAR LETTER

To the Common Stockholders of the A. B. Company:

In accordance with the resolutions voted at the meeting of the stockholders of the A. B. Company on (date), all of the assets of the A. B. Company with the exception of cash have been sold to the C. D. Company, as of June 30, 1920. The C. D. Company assumed all of the liabilities shown in the balance-sheet of June 30, with the exception of the taxes, and paid for the net assets transferred to them as follows:

Cash	\$ 126,000.00
Preferred stock of the C. D. Company at par.	878,000.00
	<u>\$1,004,000.00</u>

The Journal of Accountancy

The disposition of the assets of the A. B. Company, since the sale, is indicated by the following statement:

	Cash	Preferred C. D. Stock	Total
Cash not transferred to the C. D. Company..	\$13,000	.....	\$13,000
Received from the C. D. Company.....	126,000	\$878,000	1,004,000
Total	\$139,000	\$878,000	\$1,017,000
Payment of business profits taxes.....	50,000		50,000
Balances remaining for stockholders	\$89,000	\$878,000	\$967,000
Liquidation of A. B. preferred stock by pay- ment of C. D. preferred stock—par for par		200,000	200,000
Balances for common stockholders.....	\$89,000	\$678,000	\$767,000

The common stock will therefore be liquidated at \$255.66 $\frac{2}{3}$ per share. It is possible to dispose of \$78,000.00 of the preferred stock for cash at par, and if this is done each share of A. B. Company common stock can be liquidated as follows:

Preferred stock of C. D. Company—2 shares at par...	\$200.00
Cash	55.67
Total	\$255.67

You have the option of accepting a settlement on this basis or of reducing the cash due you under this plan in amounts divisible by 100 and accepting an additional share of C. D. preferred stock for each \$100.00. For instance, if you hold two shares of common stock, you may elect either of the following plans of liquidation:

	First	Second
Preferred stock of C. D. Co.—at par.....	\$400.00	\$500.00
Cash	111.33	11.33
Total	\$511.33	\$511.33

You will please forward your certificates before December 31, 1920, for cancellation, indicating your option as to settlement.

Yours very truly,

Editor, Students' Department,

Sir: Following is a problem taken from a C. P. A. examination dealing with consolidated balance-sheets. I have tried to solve it but find that I am unable to do so. I will greatly appreciate your assistance, and am enclosing ruled paper so that it will lighten your work.

Houston, Texas.

Yours truly,

A. A.

Students' Department

On January 1, 1916, a corporation, the C Company, was formed with a capital stock of \$6,000,000.00, of which \$5,000,000.00 was common stock and \$1,000,000.00 was preferred stock. The C Company as of January 1, 1916, purchased the capital stocks of the A and B Companies, balance-sheets of which, at December 31, 1915, are shown below. The preferred stock of the C Company was sold to the public for cash at par, the stockholders of the A Company received the entire \$5,000,000.00 of the common stock of the C Company for their holdings in the A Company, while the stockholders of the B Company were paid \$500,000.00 in cash for their holdings in the B Company.

Prepare a consolidated balance-sheet, showing the financial condition of the C Company as of January 1, 1916, after giving effect to the foregoing transactions.

It should be understood that the A Company had in its inventory at December 31, 1915, materials valued at \$250,000.00, purchased from the B Company, on which the B Company had made a gross profit of 20%.

A COMPANY

BALANCE-SHEET—DECEMBER 31, 1915

<i>Assets</i>	<i>Liabilities</i>
Real estate, buildings, machinery and equipment \$1,000,000.00	Capital stock \$1,500,000.00
Inventories 1,500,000.00	Notes payable—B Co. 100,000.00
Accounts receivable.. 500,000.00	Notes payable— Others 400,000.00
Cash 50,000.00	Accounts payable—B Co. 100,000.00
Prepaid insurance and taxes 10,000.00	Accounts payable — Others 700,000.00
	Surplus 260,000.00
\$3,060,000.00	\$3,060,000.00

B COMPANY

BALANCE-SHEET—DECEMBER 31, 1915

<i>Assets</i>	<i>Liabilities</i>
Real estate, buildings, machinery and equipment \$250,000.00	Capital stock \$100,000.00
Inventories 75,000.00	Accounts payable 140,000.00
Accounts receivable — A Co. 100,000.00	Surplus 262,000.00
Others 50,000.00	Contingent liability in respect of notes of A Co. discounted at bank, \$100,000.00 ...
Cash 25,000.00	
Prepaid insurance and taxes 2,000.00	
\$502,000.00	\$502,000.00

Solution:
THE C COMPANY AND SUBSIDIARIES
CONSOLIDATED WORKING PAPERS—JANUARY 1, 1916

<i>Assets</i>		<i>A Co.</i>	<i>B Co.</i>	<i>C Co.</i>	<i>Eliminations</i>	<i>C. B. S.</i>
Investment in stock of Co. A—100%.....				\$5,000,000		
Eliminate present book value:						
Par					\$1,500,000 A	
Surplus					260,000 B	\$3,240,000
Goodwill						
Investment in stock of Co. B—100%.....				500,000		
Eliminate present book value:						
Par					100,000 C	
Surplus					262,000 D	
Goodwill						
Cash		\$50,000	\$25,000	500,000		138,000
Notes receivable—Co. A.....			100,000			575,000
Real estate, buildings, machinery and equipment.....		1,000,000	250,000			
Inventories		1,500,000	75,000		100,000 E	1,250,000
Accounts receivable		500,000	50,000			1,575,000
Prepaid insurance and taxes		10,000	2,000			550,000
Accounts receivable—Co. A			100,000			12,000
		<u>\$3,060,000</u>	<u>\$602,000</u>	<u>\$6,000,000</u>	<u>\$2,322,000</u>	<u>\$7,340,000</u>
<i>Liabilities</i>						
Capital stock:						
Co. A		\$1,500,000			\$1,500,000 A	
Co. B			\$100,000		100,000 C	
Co. C: Common						\$5,000,000
Co. C: Preferred				1,000,000		1,000,000
Notes payable—Co. B		100,000			100,000 E	400,000
Notes payable		400,000				
Accounts payable—Co. B		100,000			100,000 F	
Accounts payable		700,000	140,000			840,000
Notes receivable discounted—Co. A			100,000			100,000
Surplus: Co. A		260,000			260,000 B	
Co. B			262,000		262,000 D	
		<u>\$3,060,000</u>	<u>\$602,000</u>	<u>\$6,000,000</u>	<u>\$2,322,000</u>	<u>\$7,340,000</u>

Students' Department

THE C COMPANY AND SUBSIDIARIES, CONSOLIDATED BALANCE-SHEET JANUARY 1, 1916

Assets

Real estate, buildings, machinery and equipment ..	\$1,250,000.00
Goodwill	3,378,000.00
Inventories	1,575,000.00
Accounts receivable	550,000.00
Cash	575,000.00
Prepaid insurance and taxes	12,000.00
	<u>\$7,340,000.00</u>

Liabilities

Capital stock—common	\$5,000,000.00
Capital stock—preferred	1,000,000.00
Notes payable	500,000.00
Accounts payable	840,000.00
	<u>\$7,340,000.00</u>

This problem contains only two points of any difficulty; the profit in the inventories, and the contingent liability of Company B in respect to notes of Company A discounted at bank.

It will be noted that no reserve is set up for the profit added by Company B to goods sold to Company A, and remaining in A's inventory. These sales were made by Company B before the holding company acquired B's stock. Since the profits were made before any inter-company relation was effected, the profit was not inter-company profit and hence does not require a reserve.

The object of a reserve for unrealized profit in inventories is to take out of the holding company's surplus any profits which it may have taken up on inter-company transactions and which have not been realized by subsequent sales to the outside world. But if the holding company has not taken up any such profits it is evident that there is no occasion to set up a reserve which would be a deduction from its surplus. After the holding company has controlled the subsidiaries for a year, or other accounting period, it would be justified in making a journal entry debiting the stock investment account and crediting its surplus account with its share of the profits of the subsidiary as shown by the subsidiary's profit and loss statement. If any of this profit, thus taken up, is unrealized from the standpoint of the organization as a whole, by reason of the fact that the goods on which the profit was made remain in the inventories of one of the constituent companies, a condition exists which necessitates a reserve. That is, the holding company has taken up profits which have not been realized, and the reserve will take these profits out of its surplus account.

But at the date of acquisition, the holding company has not taken up any of the profits made by the subsidiary companies on sales before the consolidation. Since it has not taken up any of these pre-consolidation

profits, the fact that a portion of them remains in the inventories is immaterial.

The other point is the treatment of the contingent liability of the B company on A company notes discounted. While this is a contingent liability of the B company, it is a positive liability of the consolidation because the notes are in the hands of outside parties. In Company B's balance-sheet the condition is shown by a memorandum only. In the working papers, the notes receivable—Company A appear among the assets and the notes receivable discounted appear among the liabilities. The notes receivable in B's balance-sheet are eliminated (elimination E) against the notes payable in A's balance-sheet, and the notes receivable discounted balance is carried to the consolidated balance-sheet column. This is done because the outside liability arose by the discounting of the notes.

Writers differ as to whether this liability should be shown on the consolidated balance-sheet as "notes receivable—Co. A—discounted" or as "notes payable." Those who favor the former title contend that the note is a direct liability of one of the related companies and a secondary liability of the other company, and hence is an obligation different in nature from a note signed by one company only. Showing the liability as a note payable would not indicate the liability of both companies.

In the editor's opinion the notes payable title is preferable. In the first place, the consolidated balance-sheet is based on the assumption that the related companies are a single organization, the legal fact of separate corporate entities being ignored. From the viewpoint of the consolidated balance-sheet, therefore, a note signed by one company is as much a liability of the organization as a note signed by one company and endorsed by another related company. In the second place, the term "notes receivable discounted" at once suggests a contingent liability, and since an inter-company note discounted with an outsider is a positive liability, the term is likely to be misleading.

The following problem was received from a correspondent in Jackson, Kentucky, with a request for a solution:

The capital of a partnership is contributed as follows:

A	\$90,000.00
B	45,000.00
C	15,000.00

The partnership agreement provides for profit-sharing as follows:

A	50%
B	30%
C	20%

The partners' salaries are as follows:

A	\$5,000.00
B	3,000.00
C	2,000.00

At the end of the first year's business C dies. The books are closed and the net assets of the business are shown to be \$152,500.00. A and B liquidate the affairs of the partnership and distribute the surplus assets as follows:

First distribution	\$42,410.20
Second distribution	74,622.30
Final distribution	31,967.50

Students' Department

Prepare a statement of the partners' accounts, showing how the distribution of assets should be made and the apportionment of the loss.

Solution:

The problem does not state whether the salaries have been paid, but it makes no difference whether they have been or not, because the salaries correspond with the profit and loss ratio. Assuming that the salaries have been paid, the balance in the partners' accounts at the end of the year are computed as follows:

Net assets at end of year.....				\$152,500.00
Deduct original capitals:				
A	\$90,000.00			
B	45,000.00			
C	15,000.00			
				<u>150,000.00</u>
Gain				<u>\$2,500.00</u>
				<u><u> </u></u>
	A	B	C	Together
Original capitals	\$90,000	\$45,000	\$15,000	\$150,000
Add gain	1,250	750	500	2,500
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Balances—end of year	<u>\$91,250</u>	<u>\$45,750</u>	<u>\$15,500</u>	<u>\$152,500</u>

If the salaries have not been paid, an entry would be made debiting profit and loss and crediting the partners, with the following results:

Gain, before considering salaries (as above).....				\$2,500.00
Deduct salaries				10,000.00
				<u> </u>
Loss				<u>\$7,500.00</u>
				<u><u> </u></u>
	A	B	C	Together
Original capitals	\$90,000	\$45,000	\$15,000	\$150,000
Add credits for salaries	5,000	3,000	2,000	10,000
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Total	\$95,000	\$48,000	\$17,000	\$160,000
Deduct loss	3,750	2,250	1,500	7,500
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Balances—end of year	<u>\$91,250</u>	<u>\$45,750</u>	<u>\$15,500</u>	<u>\$152,500</u>

This shows that the partners' capitals when liquidation begins will be the same whether it is assumed that the salaries have, or have not, been paid.

This problem illustrates the point that, when profit-and-loss ratios differ from capital ratios, at least one partner is in danger of being charged with realization losses in excess of his capital; under such circumstances the liquidating dividends should be distributed in such a

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manner as to reduce the balances of the partners' accounts to their profit-and-loss ratio of the remaining assets, as nearly as possible.

When liquidation began, the net assets of the business totaled. . . \$152,500.00

The first distribution was 42,410.20

This reduced the net assets to..... \$110,089.80

If all of these net assets should prove to have no value (and theoretically this contingency must be faced, because at the time of the first distribution the subsequent realizations are unknown), the loss would be divided in the profit and loss ratio as follows:

	A	B	C	Together
Capitals (as above)	\$91,250.00	\$45,750.00	\$15,500.00	\$152,500.00
Cash for distribution				<u>42,410.20</u>
Capital loss—in P. & L. ratio.	55,044.90	33,026.94	22,017.96	110,089.80
Capital less than possible loss.			<u>15,500.00</u>	
Additional possible loss to A and B			<u>6,517.96</u>	
A: $\frac{5}{8}$ of \$6,517.96.....	\$4,073.73			
B: $\frac{3}{8}$ of 6,517.96.....		\$2,444.23		
Total possible loss to A and B	<u>\$59,118.63</u>	<u>\$35,471.17</u>		

Of course C's estate should pay in the debit balance of \$6,517.96 in case all of the remaining assets are lost, but this method of liquidation safeguards A and B (so far as the distribution of the loss between them is concerned) by assuming that C's estate may not be able to pay in the debit balance.

Since C's capital is already too small to cover his share of the possible loss, it is evident that his estate should be paid nothing at the first distribution, while A and B should be paid down to the balances which indicate their possible losses for themselves and for C. It should be understood that the possible losses are not actually charged to the partners; payments are charged to them and their accounts are left with balances equal to their possible losses. This is shown in the statement of capital accounts.

The second distribution is determined as follows:

	A	B	C	Together
Capitals after first distribu- tion	\$59,118.63	\$35,471.17	\$15,500.00	\$110,089.80
Cash for distribution				<u>74,622.30</u>
Possible loss—in P. & L. ratio	\$17,733.75	\$10,640.25	\$7,093.50	\$35,467.50

Students' Department

Since each partner's capital exceeds his possible loss, each can be paid an amount sufficient to reduce his capital to his profit-and-loss ratio of the remaining net assets.

A, B AND C—STATEMENT OF CAPITAL ACCOUNTS

	A	B	C	Together
Capitals before realization..	\$91,250.00	\$45,750.00	\$15,500.00	\$152,500.00
First distribution	32,131.37	10,278.83		42,410.20
Balances	\$59,118.63	\$35,471.17	\$15,500.00	\$110,089.80
Second distribution	41,384.88	24,830.92	8,406.50	74,622.30
Balances—reduced to P. & L. ratio	\$17,733.75	\$10,640.25	\$7,093.50	\$35,467.50
Third distribution in P. & L. ratio	15,983.75	9,590.25	6,393.50	31,967.50
Loss	\$1,750.00	\$1,050.00	\$700.00	\$3,500.00

The third distribution is made in the profit-and-loss ratio because the second distribution reduced the capitals to the profit-and-loss ratio. Hence the third distribution is really made in the capital ratio.

This problem was accompanied by a solution which erred in two particulars. In the first place, after charging up salaries and ascertaining a loss of \$7,500.00 as was done in this solution, the operating loss was charged to the partners in their profit-and-loss ratio of 50%, 30% and 20%. So far correct. The error came in making the distributions in such a way that the final loss of \$3,500.00, which was a realization loss, was divided among the partners in their original capital ratio of 60%, 30% and 10%. This is an error frequently made, but a serious one, for so-called realization losses are properly shared in the agreed profit-and-loss ratio.

The second error was in requiring C's estate to make a payment to the partnership at the time of the first distribution, when it became apparent that, in the event of a total loss of the remaining assets, C's capital would be insufficient to bear his share of the loss. Although C's estate would be obligated to make such a payment if the contingency of total loss did become a reality, the payment can not be exacted until the loss is incurred. It develops in this problem that the assets were not lost, and that a claim against C's estate never did arise.

The following problem, received from a correspondent in Los Angeles, illustrates the same points as the preceding problem, but it introduces the new feature that two of the three partners have insufficient capitals to bear their possible losses, and it requires three distributions to reduce the capitals to the profit-and-loss ratio.

Red, White and Blue are partners in a mercantile establishment, sharing profits or losses in the proportion of 50%, 30% and 20% respectively. They dissolve partnership at a given date, at which time the net assets prior to realization amounted to \$200,000.00. The position

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of the partners was as follows: Red, \$140,000.00; White, \$40,000.00; Blue, \$20,000.00. The realization of the assets lasts four months, and the net collections to be distributed monthly as realized were:

End of first month, \$60,000.00; second month, \$30,000.00; third month, \$50,000.00; fourth month, \$30,000.00. Total, \$170,000.00. Prepare a settlement statement showing respectively the monthly distribution and the reasons for your apportionments.

Solution:

WORKING PAPERS—FIRST MONTH

	Red	White	Blue	Together
Capitals before distribution	\$140,000	\$40,000	\$20,000	\$200,000
Cash for distribution				60,000
Possible loss—in P. & L. ratio.....	\$70,000	\$42,000	\$28,000	\$140,000
Capitals less than possible loss.....		40,000	20,000	
Additional possible loss to Red.....	10,000	\$2,000	\$8,000	
Total possible loss to Red	\$80,000			

WORKING PAPERS—SECOND MONTH

	Red	White	Blue	Together
Capitals before distribution	\$80,000	\$40,000	\$20,000	\$140,000
Cash for distribution				30,000
Possible loss in P. & L. ratio	\$55,000	\$33,000	\$22,000	\$110,000
Capital less than possible loss			20,000	
Additional possible loss to Red and White			\$2,000	
Red: $\frac{5}{8}$ of \$2,000.....	\$1,250			
White: $\frac{3}{8}$ of 2,000.....		750		
Possible loss to Red and White.....	\$56,250	\$33,750		

WORKING PAPERS—THIRD MONTH

	Red	White	Blue	Together
Capitals before distribution	\$56,250	\$33,750	\$20,000	\$110,000
Cash for distribution				50,000
Possible loss in P. & L. ratio	\$30,000	\$18,000	\$12,000	\$60,000

Since each partner's capital is in excess of his possible loss, each can be paid down to the amount of his possible loss. That is, the capitals can be reduced to the profit-and-loss ratio.

Students' Department

STATEMENT OF CAPITAL ACCOUNTS

	Red	White	Blue	Together
Capitals at "a given date"	\$140,000	\$40,000	\$20,000	\$200,000
Cash—first month	60,000			60,000
Balances	\$80,000	\$40,000	\$20,000	\$140,000
Cash—second month	23,750	6,250		30,000
Balances	\$56,250	\$33,750	\$20,000	\$110,000
Cash—third month	26,250	15,750	8,000	50,000
Balances	\$30,000	\$18,000	\$12,000	\$60,000
Cash—fourth month	15,000	9,000	6,000	30,000
Loss—in profit-and-loss ratio	\$15,000	\$9,000	\$6,000	\$30,000

An Accountant Lord Mayor of London

Edward Cecil Moore a chartered accountant, has been elected Lord Mayor of London. Other accountants have been aldermen of the city, but this is the first accountant who has occupied the Mansion House.

Joseph Robinson, C. Scott Kinney, W. A. Thayer, George L. Kling, William J. Grigg and E. B. Jacobs, announce the formation of partnership under the firm name of Robinson, Kinney, Thayer & Jacobs with offices at 1001 Royster building, Norfolk, Virginia.

MacGregor, Hines & Co. announce the opening of offices at 600 Wilmac building, Minneapolis, Twin Cities National Bank building, St. Paul, and 202 I. O. O. F. building, Mankato, Minnesota.

Thomas U. Conner announces the opening of an office in the Calvert building, Baltimore, Maryland.

L. Murray Jaeger announces the opening of an office at 342 Madison Avenue, New York.

Julian Saviet announces the opening of an office at 303 Fifth Avenue, New York.

Marwick, Mitchell & Co. announce the opening of an office in the Clinton building, 20 Clinton street, Newark, New Jersey.

Louis Sheffield Hubbard announces the removal of his office to 140 Cedar street, New York.

Smith, Brodie, Lunsford & Wright of Kansas City, Missouri, announce the opening of offices at 315 Beacon building, Wichita, Kansas.

George B. Buist & Company announce the opening of an office at 618 Dixie Terminal building, Cincinnati, Ohio.

Shmerler & Wolfe and Fred Tourin announce the consolidation of their practices under the firm name of Shmerler, Wolfe & Tourin.

Harry H. Meisner announces the opening of an office at 1530 First National Bank building, Detroit, Michigan.

Terminology Department

CONDUCTED BY THE SPECIAL COMMITTEE ON ACCOUNTING TERMINOLOGY
OF THE AMERICAN INSTITUTE OF ACCOUNTANTS

The committee publishes below a list of words indicating the various kinds of assets, liabilities, funds and reserves; also an addendum to the lists of words, previously published, indicating the various kinds of accounts, bonds and companies and/or corporations, the month shown in parentheses representing the issue of THE JOURNAL in which the original list was published:

ASSETS

accrued
active
actual
admissible
available
capital
cash
circulating
contingent
current
dead
deferred
doubtful
diminishing
equitable
fictitious
fixed
floating
good
hypothecated
immaterial
impersonal
inadmissible
intangible
ledger
legal
liquid
material
miscellaneous
net
net quick
nominal
non-ledger
non-productive
passive
permanent
physical
pledged
productive
quick
slow
special
speculative
sundry
surplus
tangible
temporary
unpledged
wasting
working

LIABILITIES

accrued
actual
capital
contingent
current
deferred
direct
fixed
floating
other
reserve
trade
working

LIABILITY

(responsibility)

contingent
double
fixed
full
joint
joint and several
limited
primary
secondary
unlimited

FUND

accumulative sinking
amortization
benefit
contingent
debenture reserve
defense
depreciation
endowment
general
gratuity
imprest
industrial accident
insurance
investment
loan
non-accumulative sinking
obligatory
optional
pension
petty cash
redemption

relief
renewal
reserve
reserved
revolving
rotary
savings
self insurance
sinking
special
specific
strike
superannuation
trust
working

FUNDS

available
insufficient
public
surplus

RESERVE

actual
allowance
applied
bank
benefit fund
contractual
dividend equalization
equalization
excess
extinguishment
funded
hidden
income tax
industrial accident fund
insurance
insurance fund
lawful money
legal
legal minimum
liability
liquid
maintenance
minimum
necessary
nominal
non-contractual
non-operating
obligatory

Terminology Department

operating
optional
pension fund
permanent
profit and loss
profit sharing
property
proprietorship
real
relief fund
repairs equalization
required
secret
self insurance
sinking fund
surplus
temporary
unapplied
unfunded
valuation
voluntary
Reserve for accidents
(or accident liability)
Reserve for amortization
Reserve for bad debts (or bad and
doubtful debts or uncollectible ac-
counts, etc.)
Reserve for contingencies
Reserve for contracts
Reserve for depletion
Reserve for depreciation
Reserve for discounts
Reserve for dividends
Reserve for extraordinary casual-
ties
Reserve for overhead
Reserve for redemption of debt
Reserve for renewals and replace-
ments
Reserve for repairs
Reserve for taxes
Reserve for unrealized profits
Reserve for wear and tear and/or
obsolescence and/or inadequacy

ACCOUNT (June, 1922)

agents'
bad and doubtful debts
bad debts
balance-sheet
capital stock
cartage
consolidated
continuing
cooked
deductions and allowances
embezzlement
establishment
falsified

foundation
interim
inventory
losses from bad debts
marine insurance fund
non-operating
operating
price fluctuation
principals'
repair
retirements
returns and allowances
spurious
storage
supplies
suspense credit
suspense debit
uncollectible bills

ACCOUNT SALES

BOND (August, 1922)

adjustment income
assigned
callable
clean
coal
first refunding mortgage
foreign
gravel road
hypothecated
industrial
lawful money
listed
non-callable
outside
power company
public utility
railroad
railroad aid
railway trust
real estate mortgage
refunding and first mortgage
refunding and improvement
savings bank
school district
third mortgage
unlisted

COMPANY and/or CORPORA- TION (August, 1922)

appraisal
business
industrial life
lay
membership
merged
moneyed
religious
store

WALTER MUCKLOW, *chairman*
420 Hill Building, Jacksonville, Florida

EDWARD H. MOERAN,
120 Broadway, New York

J. HUGH JACKSON,
56 Pine Street, New York

Book Reviews

PRACTICAL ACCOUNTING FOR GENERAL CONTRACTORS, by
H. D. GRANT. *McGraw-Hill Book Co., Inc.*, New York, 254 pp., cloth.

Here we have another monograph, a type of book which is a welcome addition to accounting literature. After the usual preamble, the various types of construction contracts are described, an entire chapter being devoted to cost-plus contracts. Then follows a detailed description of the financial accounts, records and statements which completes part I. Part II is devoted to "field accounting control," including a chapter on organization and personnel and monthly reports. Part III, which completes the book, deals with miscellaneous matters such as pay-roll problems, legal aspects of contracts, etc.

Upon reading the book through, the first impression is likely to be one of bewilderment, especially if the reader be a student, because of the ingenuities and departures from common practice and the seeming intricacies and difficulties peculiar to accounting for general contractors. Almost at the outset (page 3), we are confronted with the following: "Contractual cost accounting requires as many, if not more, internal cost accounts than a manufacturing business, and some of the accounts are more difficult of manipulation." Incidentally this is an example of unequivocal statements which tend to shake one's confidence in the author's experience, and we respectfully suggest the deletion of "manipulation" asavoring too strongly of malice aforethought.

There are many generalizations contained in the book to which exception might properly be taken, but one example will suffice. On pages 6 and 7 the following appears: "Overhead extravagance, administration and selling expenses should be curtailed to the irreducible minimum." We agree with Mr. Grant as to extravagance in its true sense, but point out that few, if any, concerns doing a competitive business can with impunity whittle down their selling expense to the vanishing point as suggested. Successful contractors may build up each a reputation that solicitation of business, in any form, is no longer necessary, but such a point is usually reached by a "go get it" policy, involving expenditures far removed from the irreducible minimum. The term "whole cost" used as a synonym for selling price (pages 14 and 15) is decidedly objectionable and the suggestion on page 25 that material supplied from contractors' stock should be priced at cost or market whichever is higher might, in the absence of specific contract provision, lead to serious abuses and is at best a questionable practice.

The general records suggested by Mr. Grant are in many respects ingenious, to say the least. An outline of the cash record appears on page 36 and is badly designed. Among other objectionable features only one column is provided for the date of receipts and disbursements, and only one column for payor and payee, necessitating a waste of space which might be as great as 50%. The two suggested posting mediums to the general ledger are the cash record above referred to and the general journal, and the chief underlying record to the general journal is the "figure-analysis book," an ingenious device which, among other things, takes the place of a voucher record.

Practical Accounting for General Contractors, whatever its shortcomings, and, although a dangerous book for students to read, gives evidence of painstaking care in its preparation and contains data of value to those sufficiently experienced to sift the chaff from the wheat.

Apart from the accounting features of the book and textual criticism, we feel it our duty to call attention to the fact that Mr. Grant, on the title page, is described as "Auditor, Hudson and Manhattan Railroad Company." Mr. Grant was never the auditor of the railroad company, but was, we believe, auditor of one of its subsidiaries, the Tunnel Advertising Company. Also, on pages 138 and 139 there appears a comparative balance-sheet, followed in succeeding pages by operating statements, of L. K. Comstock & Co., with whom Mr. Grant was formerly associated as treasurer. The figures used are purely suppositions, but this fact is not clearly set forth as it should be. These two inadvertencies should be corrected, if the sale of the book warrants a second edition.

EDWARD H. MOERAN.

SYSTEM BUILDING AND CONSTRUCTIVE ACCOUNTING, by
RAYMOND D. WILLARD. *McGraw-Hill Book Company*, New York.
cloth, 315 pages.

Although from its general title one would expect to find this book a treatise on system-building and accounting in general, only twenty-seven pages are devoted to the general subject. Those pages contain a general outline of the problems usually encountered in designing a system, details of programmes to be followed in preliminary investigations, scope of reports to be rendered, and last but not least practical suggestions for the selection of papers to be used for different purposes and instructions for preparing forms, rulings and printing. The last-named is a feature I do not remember before in any accounting text, and it is a valuable one.

As to the remaining pages, it may be of help to the prospective purchaser who reads this review to state that it covers in full detail the organization, system and accounting for an automobile sales company, a wholesale grocery company, a large club, a wholesale leather-cutting concern, and a semi-public hospital. The treatment of each case is full and explicit, including even the proper form of journal entries for closing, etc., and all the forms for books and tickets necessary to make complete records. The systems described are in actual use, it is stated in the preface, which emphasizes the practical nature of the book. Each is typical of a large class so that with the exception of the retail trade we have the whole field of accounting fairly covered. It is primarily a text-book for students, but the practicing accountant will find it useful for reference.

Exception must be taken to the practice of the auto sales company in continuing the charge for depreciation of an expired asset as an operating expense offset by a similar credit to income. I do not suppose the author is responsible for or approves of this bit of theory gone mad, but at least a note might have been made to warn the student. (Page 71.) If the asset has exceeded its estimated life, i. e., the charge for depreciation in previous years has been overestimated, it is a matter for adjustment through the surplus not the income account.

W. H. LAWTON.

BUDGET MAKING, by ARTHUR EUGENE BUCK. *D. Appleton & Co.*, New York. cloth, 234 pages.

Budget Making is one of the series of manuals on government administration and accounting issued by the National Institute of Public Administration in conjunction with the New York Bureau of Municipal Research. In the words of the author's preface:

"It is not the purpose of this hand-book to discuss the philosophy and theory of the budget, but to present model budget forms and to outline the procedure of budget-making in such a way as to be of assistance to those engaged in the actual work of preparing budgets."

But it is more than that. For the student of government administration it is a complement to such studies as the Metz *Handbook of Municipal Accounting*, and Oakey's *Principles of Government Accounting and Reporting*, either as a preliminary view of the whole subject of budget-making or as a summary and digest of the two larger studies. In a sense it may also be considered as a report of progress of the country at large. We have become so accustomed to criticise government agencies of all classes for lack of business methods that it will surprise many to learn that no less than forty-six states have provided by statute or by constitutional amendment for the establishment of a budget system, and that scores of cities throughout the country are using budget methods in conducting their finances. That congress has adopted a budget system for the federal government is a matter of recent history. Two states, Pennsylvania and Rhode Island, still enjoy the proud distinction of clinging to antiquated and wasteful rule-of-thumb financial ways.

The first two chapters of the book deal with the budget in relation to government work and budget-making authorities and staff agencies. The purpose of a budget is to furnish a guide for legislative action, a method of control for the executive and, above all, information for the public in respect to public expenditures. It follows that the ideal budget must be not only scientifically based from an accounting standpoint, but also stated in terms that will be easily understood by the man of average intelligence. Budget-making is a continuous process involving the gathering and recording of data, preparing the estimates, formulating and adopting the financial plan, executing the plan and recording more information for future budgets, a complete cycle. How the data should be accumulated and classified, then grouped and synthesized for the purpose of informing the legislature and the public and of controlling the administration of the plan through the executive is covered by the next eight chapters. Being based on actual procedure for the most part, these instructions are practical and furnish a safe guide for state and municipal authorities. The remaining two chapters deal with administrative organization and methods, an important feature, since the most ideally scientific system of government accounting is useless without the administrative power to make it effective. Supporting appendices and a good index complete the book, which is a thoroughly good piece of work and will be appreciated by all students of government administration.

W. H. LAWTON.

Current Literature

Compiled in the Library of the American Institute of Accountants

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The JOURNAL of ACCOUNTANCY

Official Organ of the AMERICAN INSTITUTE of ACCOUNTANTS

Vol. 34

DECEMBER, 1922

No. 6

AMERICAN INSTITUTE OF ACCOUNTANTS

BOARD OF EXAMINERS

Examination in Auditing

NOVEMBER 16, 1922, 9 A. M. to 12.30 P. M.

Answer all questions.

No. 1. (10 points) :

Define and state the scope of a

- (a) Balance-sheet audit,
- (b) Complete audit,
- (c) Continuous audit,
- (d) Special examination.

No. 2. (10 points) :

Give, without figures, the form of profit-and-loss statement for a mercantile corporation as suggested by the federal reserve board.

No. 3. (10 points) :

Give, without figures, the form of an income and expense statement of a stock-broker showing titles of accounts you would expect to find.

No. 4. (10 points) :

Define and give examples of

- (a) Tangible assets,
- (b) Intangible assets,
- (c) Fixed assets,
- (d) Current assets.

No. 5. (10 points) :

In auditing the annual statement of the town of X you find all the following items of receipts stated under the general head of "Revenues".

1. Taxes received.
2. Loan from the National Bank of X.
3. Dog licenses.
4. Municipal court fines.
5. Bequest from the estate of A to establish a town library.
6. Street assessments collected from owners of abutting property.
7. Permits for parades.
8. Sale of worn-out equipment.
9. Transfer of balance from street opening to street cleaning fund.
10. Deposit by B to cover cost of extra sewer connection.
11. Interest on bank deposits.
12. Donation from C toward street repairs.
13. Annual payment under franchise by X Street Railway Company.
14. Fees from town clerk turned in.
15. Rent of city dock to steam-boat company.
16. Assessments on members of police force for pension fund.
17. Received from B balance of cost of extra sewer connection (see 10).
18. Newsstand privilege in town hall.
19. Proceeds of paving bonds sold at 110.
20. State grant for up-keep of portion of state highway included within the town limits.

Re-state the above items to show the true revenue of the town, with titles of proper accounts to be credited, and indicate how the other items should be shown or treated.

No. 6. (10 points) :

State in detail the proper method of verifying securities owned which are carried as quick assets.

No. 7. (10 points) : .

In the audit of the books and accounts of the U. S. Corporation for the fiscal year ending June 30, 1922, you find that the cashbook consists of a loose-leaf record, typewritten in duplicate. The original sheets which comprise the treasurer's records are given to you for purposes of the audit. The duplicate payment sheets go to the accounts payable department, and the duplicate receivable sheets to the accounts receivable department.

State specifically how you would ascertain in your verification of cash that these cash records were real.

No. 8. (10 points) :

The A. B. Land Co. buys a tract of land and makes improvements thereon (streets, side-walks, water and sewer connections, etc.) at a total cost of \$50,000, its entire capital. To keep the property restricted it does not sell its lots but disposes of them all in its first year on ninety-nine year leases for flat sums aggregating \$100,000, and a nominal rental of \$10 a year per lot to cover water and other service. Current expenses just consumed the nominal rentals for the first year. Then the company declares a dividend to its stockholders of \$90,000. and its balance-sheet at the close of the first year shows

ASSETS		LIABILITIES	
Land and improvements	\$50,000	Capital stock	\$50,000
Cash	10,000	Surplus	10,000
	<u>\$60,000</u>		<u>\$60,000</u>

Is this correct accounting procedure or not? Give reasons.

No. 9. (10 points) :

On December 31, 1921, Mr. A was living with his wife and two children under 18; his net income for 1921 was \$6,000. Mr. B was divorced from his wife in November, 1921, but he still maintained his home and supported his two children there, both under 18; his net income was \$2,800. Mr. C was living with his wife and one child at home, and had another child away at a boarding-school, both children under 18. His net income was \$3,000.

State the amounts of credits for personal and dependent exemption to which A, B, and C are respectively entitled in their income-tax returns.

No. 10. (10 points) :

A purchased property in 1910 at a cost of \$10,000. Its fair market value on March 31, 1913, was \$3,000. He sold it in 1921 for \$5,000.

What amount, if any, of gain or loss should A return for income tax? Give reason.

Examination in Accounting Theory and Practice

PART I

NOVEMBER 16, 1922, 1 P. M. to 6 P. M.

The candidate must answer the first three questions and two other questions.

No. 1. (23 points):

Following is the balance-sheet of the Olympic Manufacturing Company at August 31, 1922:

ASSETS	
<i>Fixed Assets:</i>	
Land and buildings:	
Land	\$8,000.00
Buildings	\$30,000.00
Less reserve for depreciation ... 6,000.00	24,000.00
	\$32,000.00
Plant and equipment	24,500.00
Goodwill	10,000.00
	\$66,500.00
 <i>Permanent Investments:</i>	
Stock of the Oak Knoll Co. (80%)	45,000.00
Advances to Oak Knoll Company (Unsecured)	15,000.00
	\$60,000.00
 <i>Current Assets:</i>	
Inventories:	
Finished goods	12,000.00
Goods in process	7,500.00
Raw material	5,000.00
	24,500.00
Notes receivable	6,000.00
Accrued interest on notes receivable	90.00
Accounts receivable	28,400.00
Less reserve for bad debts ... 250.00	28,150.00
	625.00
Cash	\$59,865.00
 <i>Deferred Charges:</i>	
Manufacturing supplies	165.00
Prepaid advertising	300.00
	465.00
	\$186,330.00

American Institute of Accountants' Examination

LIABILITIES

Fixed Liabilities:

Mortgage on land & buildings.. \$15,000.00

Current Liabilities:

Notes payable	\$40,000.00	.....
Accounts payable	35,000.00	.....
Accrued wages	700.00	.....
Accrued taxes	140.00	.....
Accrued interest on mortgage ..	150.00	.....
Accrued interest on notes payable	250.00	.....
	\$76,240.00	

Capital:

Capital stock	50,000.00	
Surplus	35,090.00	.....
Reserve for working capital ...	10,000.00	.....
	\$95,090.00	
		\$186,330.00

The Oak Knoll Company has gone into the hands of a receiver with prospects of paying its creditors at the rate of thirty cents on the dollar. The Olympic Manufacturing Company is thereby embarrassed financially, and its creditors call for a statement of affairs and a deficiency account, which you are asked to prepare.

ADDITIONAL INFORMATION AS TO ASSET VALUES, ETC.

	Estimated Value
Land	\$10,000.00
Buildings	17,500.00
Plant and equipment	15,000.00
Finished goods	9,000.00
Goods in process	3,000.00
Raw material	4,500.00
Notes receivable and interest—all good	
Accounts receivable	
Good	\$13,000.00 13,000.00
Doubtful	8,000.00 5,000.00
Bad	7,400.00
	28,400.00
Cash	625.00
Deferred charges—no value.	

The notes-payable account represents four notes, as follows:

Note for \$3,000.00 with accrued interest of \$50.00 secured by notes receivable of \$4,000.00 on which \$40.00 interest has accrued.

Note for \$25,000.00 with accrued interest of \$200.00. The holder of this note also holds the Oak Knoll stock as collateral.

Note for \$8,000.00 secured by notes receivable of \$1,000.00 on which \$30.00 interest has accrued, and by warehouse receipts for raw material having a book value of \$4,000.00 and an estimated realizable value of \$3,800.00.

Note for \$4,000.00 unsecured.

No. 2. (16 points):

Following are the balance-sheets of the Alhambra Trading Company at stated dates:

ASSETS		Dec. 31 1920	Dec. 31 1921
Land		\$3,000.00	\$4,000.00
Building		6,000.00	7,500.00
Delivery equipment		900.00	700.00
Store fixtures		1,200.00	1,250.00
Merchandise inventory		7,500.00	8,650.00
Accounts receivable		3,200.00	2,400.00
Notes receivable		800.00	750.00
Cash		675.00	405.00
		<u>\$23,275.00</u>	<u>\$25,655.00</u>

LIABILITIES		Dec. 31 1920	Dec. 31 1921
Mortgage notes		\$4,000.00	\$3,000.00
Accounts payable		7,320.00	6,135.00
Reserve for depreciation—building		600.00	750.00
Capital stock		10,000.00	12,000.00
Surplus		1,355.00	3,770.00
		<u>\$23,275.00</u>	<u>\$25,655.00</u>

The statement of surplus appears as follows:

Balance—December 31, 1920		\$1,355.00
Add: Write up of land		1,000.00
Net profit for the year		2,915.00
Total		<u>\$5,270.00</u>
Deduct: Stock dividend	\$500.00	
Cash dividend	1,000.00	<u>\$1,500.00</u>
Balance: December 31, 1921		<u>\$3,770.00</u>
Depreciation was provided during the year as follows:		
Building (credited to reserve)		\$400.00
Delivery equipment (asset written down)		300.00
Store fixtures (asset written down)		200.00

A new roof was put on the building and other extraordinary repairs were made at a total cost of \$250.00 and charged to the reserve for depreciation.

American Institute of Accountants' Examination

The mortgage notes are due serially, in annual amounts of \$1,000.00.

Prepare a statement of application of funds.

No. 3. (17 points) :

A and B entered into partnership on April 1, 1922, investing \$20,000 and \$10,000 respectively. It was agreed that each partner should have the privilege of withdrawing \$200.00 per month; these amounts were to be considered salaries and treated as an expense of the business. If either partner drew more than \$200.00 during any month the excess over \$200.00 was to be charged to his capital account at the end of the month. If he drew less than \$200.00 the difference was to be credited to his capital account. Profits were to be divided in the average capital ratio.

At September 30, 1922, the business was sold for \$30,000 and you are asked to determine how this money should be divided. The capital accounts of the two partners appear as follows:

"A"

May 31	\$ 50.00	April 1	\$20,000.00
August 31	200.00	April 30	100.00
		June 30	200.00
		July 31	150.00
		September 30	50.00

"B"

April 30	\$100.00	April 1	\$10,000.00
May 31	150.00	July 31	100.00
June 30	200.00		
August 31	100.00		
September 30	75.00		

All entries in the capital accounts after April 1st represent differences between monthly salaries and actual monthly drawings.

No. 4. (22 points) :

On January 1, 1922, a concern dealing in a single commodity, had an inventory of merchandise which cost \$20,000.00. The goods were marked to sell at 125% of cost and all subsequent purchases during the six months ending June 30, 1922, were marked at the same rate.

The selling price of the inventory at June 30, 1922, was \$24,000.00. Purchases and sales by months were:

	Purchases (cost)	Sales (selling price)
January	\$8,000.00	\$9,000.00
February	9,000.00	9,500.00
March	14,000.00	12,000.00
April	16,000.00	18,000.00
May	13,000.00	22,000.00
June	10,000.00	18,000.00

Compute estimated inventories at cost price at the end of each of the six months.

Compute the rate of turnover for the six months' period using,

- (a) the January 1st and June 30th inventories.
- (b) all of the inventories.

State which method gives the more accurate results.

No. 5. (22 points) :

A corporation issues \$500,000 of stock and \$300,000 of bonds, and purchases a mine at a cost of \$400,000. Careful estimates indicate that the mine contains 2,000,000 tons of ore, and the operating charge for depletion is computed on the basis of this tonnage, calculated at 20 cents per ton.

The officers of the company, after considering the possibility of an over-estimate in the tonnage, decide to create an additional reserve at the rate of five cents per ton mined. This conservative provision is not to affect the operating profits.

The agreement with the bondholders provides that annual sinking-fund contributions shall be made at the rate of thirty cents per ton mined during the year, and that a sinking fund reserve shall be created on the same basis.

At the close of the first year, and before making any of the reserve provisions indicated above, the profit-and-loss account shows a credit balance of \$165,000. No consideration has been given to depletion. The quantities mined may be tabulated as follows:

Sold	200,000 tons
Inventory	40,000 "
Used in operations.....	10,000 "
Total mined	<u>250,000</u> "

Contributions totaling \$50,000 have been made to the sinking-fund trustee.

Make journal entries to close the profit-and-loss account, and to set up the reserves.

Set out all known facts in balance-sheet form.

State what amount is legally available for dividends.

ACTUARIAL

No. 6. (22 points):

Fred Humiston left a will in which he directed that the income from his estate should be paid to his widow and that the principal should be held in trust for a grandson. He also stipulated that the corpus should not be impaired by the purchase of bonds by the trustee at a premium and directed that such premiums paid by the trustee should be amortized.

Humiston died on April 1, 1920. The estate contained five \$1,000 bonds of the XYZ Company, bearing 6% interest payable July 1st and January 1st. The bonds were due on July 1, 1925, and were inventoried at 104½.

On July 1, 1920, the trustee purchased five more of the same bonds on a 5% basis.

Compute the price paid by the trustee for the bonds. The present value of \$1 due 10 periods hence at 2½% is \$.781198402.

Prepare a statement showing the income payable to the widow on July 1, 1920, January 1, 1921, and July 1, 1921.

Examination in Commercial Law

NOVEMBER 17, 1922, 9 A. M. to 12.30 P. M.

Give reasons for all answers.

NEGOTIABLE INSTRUMENTS.

Answer three of the following four questions:

No. 1. (10 points):

Is the following a negotiable instrument?

"New York, June 1, 1921.

I hereby certify that James K. Sloane has deposited with me Five Hundred Dollars which I promise to pay to his order on demand with interest from date on the return to me of this instrument and of my guarantee for the note for Five Hundred Dollars dated June 1, 1921, made by said James K. Sloane to Thomas J. Smith.
(Signed) Edward F. Wilson".

No. 2. (10 points) :

How would you protect yourself against the danger involved in the loss of a negotiable instrument endorsed in blank received by you in due course of business?

No. 3. (10 points) :

What is a "notice of dishonor" and what is its purpose?

No. 4. (10 points) :

What is an "accommodation party" to a negotiable instrument and what is his liability?

CONTRACTS

Answer two of the following three questions:

No. 5. (10 points) :

A leased to B a wooden structure in the city of Rochester, New York, for a period of ten years. The lease contained an agreement on the part of A that in case the structure burned during the term of the lease, A would rebuild it for B's occupancy with all possible diligence. After about three years the building was destroyed by fire. Meanwhile the city, by an ordinance, had extended its fire limits so as to embrace the property in question, the erection of wooden buildings being prohibited. B sued A for his failure and refusal to rebuild the structure. Could he recover?

No. 6. (10 points) :

What general rule of contract law is embraced in the term "caveat emptor"?

No. 7. (10 points) :

Under the uniform sales act, what are the remedies of the seller when the buyer refuses to accept the goods contracted to be sold?

PARTNERSHIP

Answer one of the following two questions:

No. 8. (10 points) :

A and B were partners in the hardware business. B, because of illness, was prevented from attending business for a period of several months, thereby throwing the burden of conducting the affairs of the copartnership entirely upon A. After

B's recovery A demanded compensation at the rate of \$40.00 per week for the extra work which he was compelled to do. Upon B's refusal to comply with the demand the partnership was ended and A sought to recover the amount demanded by suit. Could he succeed?

No. 9. (10 points):

Smith, Howe & Rogers were partners engaged in the dry-goods business. Smith and Rogers advocated the establishment in their store of a department for the sale of groceries and similar articles. Howe opposed the plan. Could Smith and Rogers overrule Howe's objection and, as the majority partners, proceed with their plan?

CORPORATIONS

Answer both the following questions:

No. 10. (10 points):

The A. B. Corporation in the year 1921 made net profits of \$50,000. or sufficient for a dividend of five per cent. on its stock. No dividend was declared however, and X, a stockholder, sued the corporation for a sum equivalent to five per cent. on the stock held by him. Can he recover?

No. 11. (10 points):

How are shares of stock of a corporation transferred?

BANKRUPTCY

Answer one of the following two questions:

No. 12. (10 points):

What is the object of the bankruptcy law?

No. 13. (10 points):

What is a "composition" in bankruptcy?

FEDERAL INCOME TAX

Answer the following question:

No. 14. (10 points):

What is the basis for determining the gain or loss from a sale of property acquired prior to March 1, 1913?

Examination in Accounting Theory and Practice

PART II.

NOVEMBER 17, 1922, 1 P. M. to 6 P. M.

The candidate must answer all the following questions:

No. 1. (27 points):

The XYZ Chemical Company manufactures one main product only, known as "Saltero", and a by-product, known as "Scrapto."

From the following information, calculate the profit per ton (2,000 lbs.) of Saltero on every ton sold:

Saltero sells for \$600.00 per ton. The selling and administration charges are 20% of the selling price. This product is made from three ingredients, N, O and P, in the following proportions and at the following costs:

N	20%	costs	\$100.	per ton
O	30%	"	50.	" "
P	50%	"	30.	" "

Handling and storage charges amount to 10% of the cost of each ingredient.

The plant is divided into five manufacturing departments, of which A, B, C and D are engaged in the manufacturing of Saltero and E in the recovery of the by-product, Scrapto.

The following table shows the cost of direct labor per ton of product handled and the percentage of department factory expense to the direct labor:

Department	Direct labor per ton	Percentage of departmental factory expense to direct labor
A Mixing	\$25.00	75%
B Furnaces	12.50	300%
C Washing & drying.....	15.00	100%
D Grinding & packing.....	50.00	50%

General factory expenses that cannot be charged to any one department amount to 50% of the total direct labor.

In department B there is a yield of only 75% of Saltero from the tonnage of the ingredients mixed; the other 25% is treated in department E and one-half of this 25% is recovered as the by-product, Scrapto, the other half being entirely waste.

A net profit of \$40.00 per ton is made on the sale of Scrapto after all expenses of every kind are charged against it. No charge is made against Scrapto for the raw material from which it is recovered.

No. 2. (30 points) :

On January 1, 1915, a company issued \$10,000,000, 10 year, 6% convertible bonds, interest payable semi-annually on July 1st and January 1st. The bonds are convertible at 105 and accrued interest into capital stock at par (100) and accrued dividends on any February 1st or August 1st after 1918, and balances are to be adjusted in cash. The stock pays regular quarterly dividends of 2% on January 15th, April 15th, July 15th and October 15th, respectively.

The bonds when issued were underwritten at 96 by A, B & Co., bankers, and legal, printing and other expenses were incurred, incident to the issue of the bonds, amounting to \$100,000, which was set up on the books, together with the bond discount, as a deferred charge to be amortized over the life of the bonds. There is a provision in the trust deed giving the company the option of calling for redemption at 105, on any interest date after 1918, any part of the bonds then outstanding (in multiples of \$100,000) with the usual requirements as to due notice, etc.

On February 1, 1919, \$3,000,000. bonds were converted

On August 1, 1919, \$2,000,000. bonds were converted

On February 1, 1920, \$1,000,000. bonds were converted

On March 1, 1920, \$1,000,000. bonds were bought in the open market at 104 and accrued interest and thereupon cancelled.

During April, 1920, \$1,000,000 bonds were called for redemption on July 1, 1920, but only \$990,000 of the called bonds were delivered for redemption on that date and the balance of \$10,000 was still outstanding at the close of 1921. The July 1, 1920, coupons were detached from the called bonds redeemed and were separately paid.

(a) Formulate journal entries reflecting the above described transactions with respect to the issue, conversion (February 1, 1919, transactions only), purchase and redemption of the bonds. Provide for a "bondholders' conversion clearing" account to clear the conversion transactions and give effect, by

journal entry, to the cash liquidation of the balances incident to those transactions. Also provide for the following accounts:

"Accrued interest on convertible bonds"
"Accrued dividends on capital stock"
"Premium on convertible bonds"

It is not desired that you set up the above suggested accounts in ledger form but merely provide for them in your journal entries; make a brief explanation of each journal entry, commencing with the words, "To record the...."

(b) State the balance in "unamortized debt discount and expense" at the close of 1918, 1919, 1920 and 1921, amplified by a summary showing how you have arrived at your answers and giving consideration to the propriety of carrying, as a deferred charge, that portion of "unamortized debt discount and expense" applicable to called bonds unredeemed. Prove the balance at the close of 1921 by an independent computation.

(c) State whether interest should or should not be accrued after July 1, 1920, on the \$10,000 called but unredeemed bonds. Would your answer be the same with respect to interest on matured bonds outstanding?

(d) State when and how you would dispose of the "accrued dividends on capital stock" account and the "premium on convertible bonds" account.

Note: In answering the above questions, take cognizance of years, months and half-months and no other periods of time.

No. 3. (10 points):

Under what conditions is it impossible to set up on the general books, before the stock books are closed, the exact amount of dividends declared? Assuming these same conditions, is the maximum amount payable under the resolution known before the stock books are closed?

American Institute of Accountants' Examination

No. 4. (10 points) :

In auditing the accounts of the M & N Corporation for the period ended September 30, 1922, you find the following items:

(A)—Bonds maturing November 1, 1922.....	\$5,000,000
(B)—Cash on deposit with trustee to meet maturing bonds as above	5,000,000
(C)—Bonds maturing April 1, 1940.....	7,500,000
(D)—Outstanding notes of \$300,000 each, given under an agreement to purchase for \$2,000,000 the land upon which the corporation's plants are erected. These notes are of equal amount, maturing serially on February 1st of each year	900,000
(E)—A claim against the company for damages which, in the opinion of the corporation's attorney, will be settled for \$35,000	50,000

State how you would show the foregoing items on the balance-sheet to which you would certify as of September 30 (October 1), 1922.

No. 5. (23 points) :

You are requested to make an audit of a concern which keeps its books on a cash basis and you receive instructions to prepare a revised statement of profit-and-loss and surplus for the year ended December 31, 1921, and a revised balance-sheet as at January 1, 1922, upon an accrued basis. The books of the company were closed at the end of each year and had been closed for 1921 prior to the commencement of your audit.

What entries would be necessary to bring the books into conformity with your statements, so far as the following insurance account is concerned?

What would be the amount of insurance shown on your profit-and-loss account and what items, taken from this account, would appear on the balance-sheet?

INSURANCE ACCOUNT

1920	DEBITS		
July 2	Premium on fire insurance policy (building) covering period from 8/1/20 to 7/31/22	\$2,400.00	
Aug. 15	Premium on fire insurance policy on stock of goods — period from 8/1/20 to 7/31/21	1,800.00	
Sept. 1	Premiums on employees' fidelity bonds—period from 8/1/20 to 7/31/21.....	3,000.00	
Oct. 25	Shortage of R. Jones to be reimbursed by Fidelity Insurance Company	900.00	<u>\$8,100.00</u>

The Journal of Accountancy

1921

Feb. 8	Premium on liability insurance on trucks and salesmen's autos—8/1/20 to 7/31/21	\$4,500.00	
Mar. 31	Fire insurance on new building during construction—3/31/21 to 7/31/21.....	7,500.00	
Apr. 5	Additional premium on fire insurance (building) due to increased valuation—4/15/21 to 7/31/21	250.00	
July 1	Premium on fire insurance policy (building) 7/1/21 to 6/30/22, covering new building and increased valuation of old building	1,500.00	
Aug. 1	Premium on fire insurance policy on stock of goods—period 8/1/21 to 7/31/22....	1,400.00	
Aug. 1	Premiums on employees' fidelity bonds—8/1/21 to 7/31/22.....	3,000.00	
Dec. 15	Defalcation of P. Smith to be reimbursed by Fidelity Insurance Company in 1922	2,000.00	<u>\$20,150.00</u>

CREDITS

1920

Dec. 1	Refund due to reduction in rate on fire insurance on building—period 12/1/20 to 7/31/22	\$ 200.00	
Dec. 31	Transfer to profit-and-loss to close, out account	7,900.00	<u>\$8,100.00</u>

1921

Apr. 15	Payment by Fidelity Insurance Company, reimbursement for loss — R. Jones — 10/25/20	\$ 900.00	
Dec. 31	Transfer to profit-and-loss to close out account	19,250.00	<u>\$20,150.00</u>

1921

Dec. 31	Premium on liability insurance on trucks and autos — period 8/1/21 to 7/31/22, amounting to \$4,500.00—had not been paid.		
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Importance of Accounting in Gas Rate Cases*

BY ARTHUR W. TEELE

When one stops to consider the importance which attaches to accounting as one of the instrumentalities in the determination of a gas rate case, one is likely first to think of the three main questions which must be answered, viz:

- (1) What in the particular circumstances does it cost to make and distribute gas?
- (2) What is the amount of capital upon which a fair return should be earned by the company?
- (3) What rate of return is the company entitled to receive?

The last question is one in which accounting plays no part; the answer is usually the opinion of either some kind of a regulatory commission or some court of competent jurisdiction.

The first question can be answered by reference to the accounts, but it will of course require a considerable amount of explanatory and supporting testimony to satisfy those who are not intimate with the daily procedure in the operations and in the accounting. Nevertheless, if the company's accounts and records have been properly kept they can be relied upon to show what the cost is to the company.

The second question may be answered by reference to the accounts if it is determined that the capital upon which the return is to be calculated shall be fixed at the amount invested by the company. If it is to be on any other basis it will become largely an engineering problem, in solving which access to the accounts and records of the company will be of valuable assistance. Judge Learned Hand, in his opinion in the Consolidated Gas Company case, said in part in regard to the admissibility of the books of account: "Most of the evidence and testimony in the case at bar necessarily depended upon the records of the plaintiff contained in books of account of all descriptions supported by vouchers, books of original and secondary entry."

The acceptance of the company's accounting records as evidence in the rate cases of the Consolidated Gas Company of New

*A paper read at the annual meeting of the American Gas Association, Atlantic City, October 25, 1922.

York and the associated companies, without recourse to common-law proof of their correctness, has had the effect of making such records more important than ever before; therefore, it is very necessary that each transaction shall be accurately recorded at the time of its occurrence and the record made so complete in all its details that whoever examines it at a subsequent date will not be in any doubt as to what actually occurred, but will be convinced by the very completeness of the story and the support given by the underlying documents.

An old definition of book-keeping is "the science of accurately recording business transactions in an orderly and systematic fashion so that the results of such transactions may be readily determined." Since the day when that definition was written there have been many attempts to prescribe standard systematic methods of recording the business of groups or classes of companies having similar transactions. However, most of these so-called standard systems have resulted only in a uniform classification or nomenclature of accounts, so that when one sees the titles appearing in balance-sheets, income and profit-and-loss accounts and cost statements which have been prepared from ledger accounts set up under such a uniform classification, one infers that the figures are ranged under the titles in accordance with established definitions and a common understanding. A classification of accounts, by itself, however, does not constitute a uniform system of accounting. To produce a system of accounting one must first consider the nature of each kind of transaction, and then what is to be the initial step in recording each, and then the succeeding steps in the order of their occurrence as each transaction progresses to its conclusion. This means the classification of the transactions into groups, such as the obtaining of materials and recording the various steps from the initial requisition, through purchase, receipt, storage, distribution for use, consumption and payment; the requirement for labor, its engagement, the initial and subsequent rates paid, the work performed and the actual payment to the laborer and the discharge at the end of service; also the outside services employed ordinarily classified as expense; the sale of the product and the necessary steps to ensure the company's collecting in cash, thus completing the cycle of conversion from cash outlay to cash income.

It would seem that all companies having the same kind of transactions could agree on the best procedure to be followed and the best standard forms to be adopted and uniform information to be recorded on such forms. Difference in volume of business is of course one reason why standard forms and rules of procedure are not more generally adopted, but this situation is easily met by providing standard modifications, as is done by some authorities creating condensed classifications of accounts for companies doing a smaller volume of business.

The advantages to be gained by the adoption of standard forms and uniform procedure, together with uniform classification of income and expenditure, and uniform cost and income statements, are that the integrity of the accounts and the reliance upon statements prepared from them is increased many fold and a comprehensive comparison of results between periods of time or between the operations of different companies may readily be made.

In the rate cases to which I referred the defendants sought by every means they could think of to discredit the accounting records and the statements prepared from them and put in evidence. Too much credit cannot be given for the carefully planned methods of accounting, and carefully preserved underlying documents, not only for one, two or three years, but for many years past, which stood the test of the critical examination made by those who were using every effort to discredit those records.

I cannot impress too strongly upon the minds of accounting officers the absolute necessity of making the daily records so complete that whoever in the future may have occasion to examine them, whether from a friendly standpoint or otherwise, will not be in doubt as to how the conclusions set forth in the entries have been reached. The necessity for clearly stated records applies particularly to public utilities because the making of rates rests so largely upon reliable accounting and engineering information, and even the latter must be incorporated in the accounts.

I cannot leave this particular point without referring to the splendid work in this direction of standard forms and uniform procedure which has already been accomplished by the Railway Accounting Officers Association. The 1922 edition of their work contains 468 pages including standard forms to the number of over 200. Of course, the railways have been forced to do this

because of the vast number of inter-company transactions, but it shows to what extent such uniform methods can go with advantage, and they are far from the end. I am also not unmindful of the work which is being undertaken by the National Association of Railway and Utilities Commissioners through its committee on statistics and accounts who have drafted a uniform classification which has been adopted by some eight or nine states and is being considered for adoption by many others. The work they have performed is along the right line and I am told will be followed by a standard form of annual report. When these two tasks shall have been successfully accomplished, it seems to me essential that their committee should then turn attention to the preparation and promulgation of standard forms and rules of procedure.

There are many accounts, particularly those kept by companies doing both a gas and electric business, which have to be distributed between two or more departments or perhaps shared by two or more companies. The basis, and the authority for it, upon which such a division is made, should be clearly set down in a book of permanent record, for it is quite reasonable to expect changes in conditions from time to time and therefore justifiable changes in division, and unless there is a permanent record provided it is too frequently carried in the memory of some individual or committed to a loose sheet of paper that sooner or later finds its way into the waste basket. It certainly would be very helpful to a witness at a hearing, or to an accounting officer who has to explain the division of the account to some unfriendly examiner, if a permanent company record could be produced bearing evidence that the matters dealt with have had careful and systematic consideration and treatment. In making divisions that are based upon the conclusions of some one other than the accounting officer, that officer should have a clear understanding of and agreement with the basis used, so that no embarrassment will arise in his explanations.

One of the most important elements of the accounting, and one which will have great influence in establishing the reliability of the records, is the manner in dealing with materials and supplies of all kinds. Companies that do their own meter repairing and deal in appliances and also undertake their installation and repair have a somewhat more complex problem than one that is

limited to the handling of materials for making gas, installing and repairing mains and services, repairing plant, etc. From the moment when authority is given for purchase down to installation, consumption or (if a sale is made) receipt of cash, the recording of each step must be provided for, and the stock records of materials received and issued must be so arranged that inventories can be readily checked and differences satisfactorily accounted for.

The movement of meters and appliances in and out of stock rooms, or in and out of repair shops, is not difficult to follow, and forms should be provided on which proper records can be made; then the physical inventory of these at any time can be easily verified or discrepancies reconciled. In pricing these inventories, however, certain distinctions must be made. The meters will probably always be a part of the company's permanently invested capital and should be taken at cost, and while the appliances may be a part of the invested capital and should then be similarly valued, it is more likely they will be a part of the working or trading capital, and pricing should then follow the general rule for merchandise inventories, that is, cost or market, whichever is lower.

Shop inventories, such as pipe, fittings, lead, oakum, etc., can be quite readily priced at average cost if stock accounts are kept in detail, as they should be, not only to account for the materials purchased, but so that the quantities of stock on hand can be controlled and requirements anticipated.

When stocks and inventories of coal and oil are to be dealt with there is a somewhat different problem and difficulties arise because the inventory in both cases has to be estimated and the quantities which are billed at time of purchase are not those actually received. The coal that is received was weighed on the car at the mine, but has since traveled many miles exposed to the elements and in some cases has been subject to rehandling and perhaps to pilfering. It is often stored in stock piles in the open for long periods and the quantity used is commonly estimated on the basis of the average weight contained in the coal buggies used.

Oil is measured at the shipping point and transported in tank cars or barges, pumped into storage tanks and used under various conditions of temperature and after more or less precipitation

of foreign substances to the bottom of storage tanks. The quantity used is calculated by measuring the quantity in the storage tank at regular stated times, the difference between two consecutive measurements giving the quantity used, taking into account, of course, any additions to the tank. These determinations are made by the works superintendent, or under his directions, and it is probably safe to say that every one of them knows that sooner or later an adjustment will have to be made when the tanks are cleaned out and also is bearing in mind that now and then a wild day in the works may have to be taken care of on the cost sheet. The quantity purchased is computed and paid for on a fixed temperature basis. However, in computing the quantity used, temperature is seldom taken into account. Meters on the generator floor, and sometimes at other points in the feed line, furnish measurements which when compared with the calculations from tank contents give some protection against too wide a discrepancy.

Regular routine in making these measurements and setting them down in a systematic fashion in a bound book, so that they may be effectually preserved, will go far toward convincing any one who has occasion to refer to them that the company endeavored to make true records, and when large adjustments are made, if they are fully set forth in such a book, there is not the question about them that arises when records of this nature are carelessly put on loose sheets with inadequate explanations, especially if some of the sheets are missing when the time comes for the company to justify its statements.

If coal can be stored in bins or piled so that lots can be kept separated then the stock accounts can be kept to correspond with the lots in storage, and as each lot is cleared up the actual difference between the billed tons and the issued tons can be adjusted with a degree of certainty not obtainable in any other way.

In some operations credit is taken for residuals as produced; in others only as they are disposed of. In the first case, of course, inventories have to be taken into account and these must be estimates based upon tank measurements, giving probably as accurate statement as any method that could be adopted. The important point is that whatever reports of measurement or calculations are made they should be carefully dated and signed by the man who makes them, and if he has no official authority they should subsequently be approved by some one with such authority.

Other gas-making materials and purification supplies are of such small amount that they are relatively of slight importance; however, the company accountant whose records are not what they should be would better put his house in order in the small matters as well as the large ones, for a clever opponent may find the weak spot and use the opportunity in an effort to discredit something he knows he cannot otherwise disturb.

When one considers what are the best records to substantiate the expenditure for labor, it will be found very necessary to go behind the well-prepared and certified payroll which serves only to justify the cash payments made by the paymaster. At the works there should be kept a record to show for each day the attendance or absence of each employee and his occupation, and this should be signed daily by the official having jurisdiction over them. From this primary record the payroll can be prepared and also the statement showing to what account or accounts each employee's time is to be charged. The rates of pay may be set down in the primary record or they may only appear on the payroll, but wherever the initial record is made it should bear the signature of the one having authority to fix the rates of pay. Where one man works in several different occupations during the day or week, so that his time is chargeable to different accounts, the record should be clear so that the distribution of the payroll when finally made up can be checked against the record at any time thereafter. A primary record of attendance, occupation and rate of pay is necessary in every department and is particularly so in the shops. A daily slip for each man which provides printed descriptions of standard jobs performed and can be signed by the workman and approved by his foreman forms a basis for both payroll and distribution of charges which it is difficult to dispute successfully. A record thus made from day to day is infinitely more convincing than the strongest testimony based on memory.

Whenever any of these labor charges are to be made to fixed capital accounts, the approval and the signature of the engineer having jurisdiction over the work performed should be upon the statement of distribution of payroll. When it comes to wages of office and sales department there should be some record provided wherein the daily attendance can be noted and from which the payroll can be prepared, and also the distribution of the charges. Here, again, the one in authority should record his

approval and signature on the statement showing the distribution of charges as well as on the payroll. The company accountant should bear in mind that it is primarily a part of his responsibility to see that the underlying data, from which the bookkeeping entries are to be formulated, are complete and that they bear evidence on their face of having been before some one having jurisdiction who approves the record so far made.

Under an order, effective January 1, 1918, the then public service commission for the first district of New York provided a uniform method of dealing with so-called fixed capital accounts to the end that the capital accounts shall at all times disclose the cost of all property in service and also that the cost of property retired, whether replaced or not, may be readily ascertained. Whatever objections or criticisms may be offered to the detailed instructions contained in the order no one can successfully contend that the accounting records provided are unsound in principle; probably the most vigorous objections arise from those whose accounts satisfy their own company officers and where information can be obtained when desired by doing a lot of digging. The best time to dig is when making the initial entries, and the time to make the best analysis is when the current entries are coming through and all necessary facts are ascertainable. Then if the record as first made is not complete and satisfactory those who know and can furnish the necessary information are at least get-at-able. Some company accountants have a shyness about putting new accounts on the ledger and if specific accounts are required by commission regulations the addition of supplementary accounts may seem disturbing in some cases, but it is not necessarily so. If you want to limit the accounts and titles to those prescribed there is nothing to prevent arranging your ledgers to have as many columns in one account as may be convenient or useful, or you may keep a supplemental record in which the prescribed ledger accounts are sub-divided to furnish any analysis, and if you post direct from vouchers or journal entries it makes little difference whether the account in which the posting is to be made is one in one hundred or one in one thousand; but when information is wanted it is far easier to look at one account and find there in one group the items wanted than it would be to search through a ledger account with many various items entered in it and have to look at all before being able to select

those required. Then, again, the items appearing on the cost sheet will not be identical with the prescribed accounts, but it is not difficult to sub-divide those accounts by using columns as above suggested so that the figures appearing on the monthly cost statement can be found in the ledger accounts. The accountants for the commission, whoever they may be, will not find fault, inasmuch as whatever information they may require will be easily obtained from your records, and, what is of more account, your own staff will not be forced to work so many nights of overtime when some special report is gotten out to answer some well or ill-considered question. Whatever is done with respect to analytical ledger accounts, be sure that the vouchers, journal entries or pay-rolls from which your postings are made bear the endorsement of approval of the officer authorized by the company to approve the expenditure, and, if material is received, that the officer or employee designated to receive it certifies to its receipt, either upon the vendor's invoice or upon a separate report form, and when this material is issued that some one responsible for its use knows that it has been issued and gives evidence of it by written approval.

All that I have said with regard to the accounting is really along the lines of the procedure which is necessary to the substantiation of the accounts. If a prescribed classification is used it creates a presumption of a certain order and significance in the accounts, but if the accounts are to be finally justified all the entries must be supported by full, clear, authoritative, underlying documents.

When accounts are properly built up in accordance with a prescribed classification under a regulatory commission, they have a significant value to the company making them. If the classification in use were standardized in all states and amplified by the adoption of standard rules of procedure and forms, the companies' position would be greatly fortified and the public authorities would have all the more assurance of the integrity and reliability of the results produced, the careful and honest consideration of which at any time should enable them to determine whether or not a revision of rates were necessary.

As it is today, the opinion of the supreme court of the United States, in the case of the Consolidated Gas Company, says:

"These books were kept in the ordinary course under general supervision of the commission, appeared free from suspicion of dishonesty, were submitted to appellants' experts and were the only readily available sources of detailed information concerning the company's affairs. In the circumstances we think no harm resulted from admitting them as *prima facie* evidence."

Is it not of especial significance that in a given case accounts well kept, supported by documentary evidence honestly prepared and carefully filed for reference when necessary, not only convinced the master hearing the case, but also the district judge and the highest court in the land, that they could be relied upon?

“Why Should We Have a New Federal Tax Law?”

A REPLY

BY FRANK W. THORNTON

In an address before the American Institute of Accountants at Chicago, Robert H. Montgomery, who has ably represented accountants on many occasions, took occasion harshly to chide congress for a large part of the evils which the country endures.

A congress having the pleasure of a LaFollette always with it is unlikely to be unduly sensitive to indiscriminate reproof and even if it were sensitive it would hardly care for defense from me. But in view of the circumstances of the address and the prominence of the speaker it may be desirable to show that not all accountants are afflicted with the mental condition which the address indicates.

The whole of the speech seems to be based on the old aristocratic theory that the law-making body should be made up of men of better type than the average of us all, and that they should legislate, not as their constituents want, but as their superior intelligence directs. I think that is a desirable theory, but it is not the theory on which our government is based.

The first count in the indictment is that the desire for reëlection is a malignant disease. Probably the great majority of our representatives serve out of desire to save the country; their repeated applications to the voters for offices are exhibitions of self-sacrifice. Anyway they say so; and they probably feel that their continued service is all that saves us from worse things. Mr. Montgomery, who is a hardy perennial as an office-holder (not paid) in the American Institute of Accountants and its predecessor, and who has helped the profession immensely thereby, should appreciate the high motives which cause the congressmen to go on working for the nation.

Desire for reëlection naturally induces a study of the means of reëlection, among which the greatest is conduct in office pleasing to the voters. Where there is no such desire and consequently no fear of defeat, congressmen are likely to use their own discretion rather than represent their constituents.

The indictment of congress then charges that it proceeds on the theory that all large profits are illegitimate. A plea of guilty must be entered; but that theory is the theory held by the great mass of voters which it is the duty of congress to represent. In any mixed public assembly an attack on "bloated corporations" or on "profiteers" is warmly cheered. The American people, especially the large mass of relatively ignorant and unthinking men, are for the time being resentful of the propriety of others, and congress represents them in duty bound. Then why nag congress? Remembering that the vote of Mr. John Dempsey, the specialist in face massage, has and in conformity with the American theory of government ought to have just as great weight as the vote of a Montgomery, and that there are many more voters of that type than of the Montgomery type, congress would be derelict in its duty if it did not give effect to the will of the majority.

The charge that congressmen are stupid and have not read in history what qualities are needed to gain for them "love and blind support" seems rather inconsistent with that other charge that they are too anxious and too successful in retaining office.

It is charged that congress has had an enormous output of idle talk and needless and hurtful legislation with less than one law per year of benefit to business men. It may be so; certainly the government regulates nearly everything—nay, what with prohibition, milk laws, health laws, food laws, meat inspection, the large cold feet of the government are each year more firmly planted on our poor stomachs. Would that our feet might be planted on quite a different portion of the anatomy of the government! But Mr. Montgomery and I are re-actionaries, out of line with the general drift of the opinion of American voters. Congress, on the other hand, does reflect the opinions of the voters.

Almost every association of men in this country wants some special restrictive legislation; the barbers want licenses for barber shops, public accountants' societies have been clamoring for more restrictions and the K. K. K. wants some. Only labor unions object to more restrictive laws, and they want to make the restrictions for themselves without submitting to restriction of others.

In the circumstances it is marvellous that congress has so far satisfied all the clamoring mouths that its members can se-

cure a large measure of that reëlection that Mr. Montgomery deplotes. They must be doing what their constituents want.

It may be said that voters elect congressmen because of party pressure, not on account of personal merit nor because of what candidates will do if elected. Indeed, the speaker digressed from belaboring congress to smite business men, calling them political dumbbells and accusing them of blind support of party nominees. Yes, but if enough voters to elect a candidate prefer party regularity to every other thing why blame the candidates?

Then congress is charged with legislating with the intent of favoring the idle rich as against the industrious rich, the specific ground being the freedom from income tax of certain securities in which the idle rich may invest their money. This is rather an ingracious charge. Surely the speaker knew that the exemption of state and municipal obligations antedates income taxes, is founded on constitutional provisions and cannot be set aside by congress. When Liberty bonds were issued congress did try to give the small holder an advantage over the large one.

So far as regards the enormity of the tax on business men and on prosperous men generally, there can be no argument; but the money is spent for things for which voters clamor. For instance, there was ample popular support for the building, after the war, of more ships for the government to run at a loss; and now that those ships have made it unprofitable for established lines to operate the remedy is another expense—a bonus to shipping—which is to be added to our other burdens amid general rejoicing.

It was not congress, but popular clamor stimulated by such as Mr. Hearst, that prevented the sale of the Leviathan when it was costing some sundry millions to care for while idle. Now more millions are being spent to refit it, although up to this date (October 1st) we are informed that the government does not know just what to do with it, but hopes to use it in service to Germany or England or somewhere maybe. All this is on the demand of the people at large. The vessel is pretty sure to run at a heavy loss; why not punish Germany by giving it back?

The complaint that taxes are assessed especially on successful business is well founded. We hardly realize how our system

looks to others. A highly educated and influential Japanese said to me

"In this country (Japan) we try to tax each person of business enough to cover the cost to the government of services rendered to or for him, each paying his way; in your country (U. S. A.) the money is taken from those who have made profits to pay for services to those who have made less. It seems to be a system suited to a pauper nation."

That is exactly what Scotland Neck demands; trade unions, farmers, laborers, reformers, all ask for it, although it argues little self respect and in the end defeats its own purpose. For, while in an emergency a special burden may be laid on business, that burden will be shifted to the consumer if the special exaction becomes a systematic impost. We all pay now, directly or indirectly, and the form of paying bears the humiliating appearance of pauperism. But the voters wanted it and elected congressmen to give it to them. Why blame congress?

The output of congressional talk is great, as charged; we do not have to read it. Mr. Montgomery knows the exasperating waste of breath in even a small gathering of C. P. A's., who are, of course, the salt of the earth and models of efficiency. Seeing that the obstruction to business arising from garrulity increases in geometric rates with the number of talkers, is it that surprising that all those congressmen, each with a constituency to satisfy, manage among them to say many words?

A "graph" showing the curve of increase of government expenditure for the last twenty years indicates that if the present rate of increase continues our children will pay all their income to the government and then owe some. This is "progress." We live in a progressive age when every one wants something—with an appropriation attached—a bonus for ships, or one for soldiers, or a commission to regulate prize fighters or an increased tariff or some blue laws or some censors or an embargo on dyes, or a bunch of inspectors to inspect somebody else or a navy yard at Canarsie or regulation of the privilege of working as a barber or as a certified public accountant; and everybody wants somebody else to pay; and as the prosperous are in a minority and helpless—well, let them pay. Really, congress is holding back the flood as well as could be expected.

In one way Mr. Montgomery is logical to a degree that he probably did not realize; if congress did pass the laws that he

"Why Should We Have a New Federal Tax Law?"

wants—I want them, too—there would be no further trouble with inordinately prolonged office-holding, for when the voters really object to what is done they do act. Remember what they did to Wilson. We are in a minority; our quarrel is with the lack of perspicacity of the majority, not with congress. Perhaps the speaker is a student of the classics; there is a poem called "O'Brien" containing these wonderful lines:

 "If I cannot have his life
 Then I'll go and lick his wife
 But I'd rather give the licking to O'Brien."

Valuation of Inventories*

By W. A. PATON

It is a commonplace to say that in the case of almost any business enterprise the valuation of the inventory is an extremely significant part of the work underlying the preparation of the financial statements. The influence of the closing inventory balance upon the exhibits of net income and financial condition is of such consequence as to call for the most searching scrutiny of inventory practices and an insistence upon the use of rational and accurate principles and procedures. Particularly in these days of serious tax levies upon incomes and profits has the entire inventory process become a matter of the utmost importance to all concerned. The business man can no longer be satisfied with an inventory calculated by the cubic yard, for example, a method avowedly favored by a friend of mine in the book business. And certainly in present circumstances the accountant cannot possibly justify himself in a procedure which permits hours of time to be devoted to the finding and correction of small clerical errors in the purchases account, for example, and fails to provide for adequate attention to an inventory valuation running into six or seven figures.

I think all will agree that the problem of pricing the inventory has not yet been adequately settled. Any one at all familiar with actual conditions must admit that the inventory is usually the most dubious figure in the financial statement. It may look very precise—for example, \$117,632.48—but it usually covers a multitude of sins. Frequently the entire process of taking and pricing is full of juggling and guess-work and, to cap the climax, a thoroughly unreasonable theory or scheme of valuation may be employed. In part, I believe, the responsibility for this situation may be charged to accountants and others who in constructing and passing upon the accounting statements have either ignored the problem of valuation or have contented themselves with a nominal advocacy of arbitrary and improper valuation devices. It seems clear that the fundamental purposes underlying the determination of the inventory have not been sufficiently emphasized; the assumptions and implications involved in the various methods and

* Paper read before a regional meeting of the American Institute of Accountants at Indianapolis, 1922.

principles which are employed have not been fully perceived and assayed; and undoubtedly too much effort has been expended in endeavoring to work out some universal formula or rule, some A B C of valuation, which might be safely utilized in every situation.

May I interpolate here a brief statement with respect to the accountant's relation to valuation in general? The crux of accounting theory and accounting practice, it seems to me, is valuation. This need not mean that the accountant is obliged to study intimately the underlying laws governing the determination of market prices. His is a specific and concrete task. The problem facing the accountant is that of periodic revaluation—that is, it is his business to register the flow of values into the particular business enterprise and to follow these values as, attaching to manifold structures, commodities, services and rights, they become affected by the business process and all attendant circumstances. The allocation of the value data of the particular enterprise to particular periods of time in terms of the essential statements, income-sheet and balance-sheet, is the essence of accounting, and this involves revaluation at almost every point.

I realize that some would challenge the validity of the implication that the accountant must actually determine values. It might perhaps be urged that this is the function of the engineer, the manager or the owner. This is, of course, an unsettled question. Nevertheless it seems to me that in substantiating the proposition that he is something more than a bookkeeper, something more than a recorder, classifier and checker of routine business transactions, it is precisely in the field of valuation that the accountant finds one of his big opportunities. The revaluation of assets for the purpose of discovering rational income and balance-sheet figures is a task lying distinctly within the province of the accountant. He cannot draw a single conclusion of fundamental significance without valuation. And, further, the process of valuation is undertaken primarily for the purpose of disclosing the very figures the accountant is endeavoring to report. Can it not reasonably be said, then, that the actual work of valuation, at least in its critical aspects, falls within the realm of the accountant's activities?

It is not intended to suggest that to be truly successful the accountant must of necessity be an appraiser, must know all about

the service lives of various classes of fixed assets, must be an adept in weighing or enumerating stock on hand. By all means let the engineer or someone else do as much of this work as he will. (Even the counting of cash shortly becomes rather monotonous when the funds belong to someone other than the counter.) The accountant's valuation work lies primarily in planning the depreciation policy—recognizing all its assumptions and implications with reference to current income, present value, liquid assets, replacement expedients, undivided profits, etc.; in supervising inventory methods and in developing rational devices and rules for valuing merchandise and materials; in determining the costs of work in process and finished stock on hand; in computing contractual accruals and preserving the distinction between income and capital in the case of bonds and other securities; in establishing the immediate value of receivables; in gauging the significance of goodwill and other intangibles.

But I must return to the particular phase of valuation which is supposed to constitute the subject of this paper. And let me hasten to limit my topic still further. The treatment of shopwear, obsolescence and related matters will be ignored. There will be no consideration of the complexities of costing to obtain work-in-process and other manufacturers' inventories. All reference to the serious complication introduced by the changing value of money will be avoided. Instead, attention will be directed to a few selected theories and devices for valuing or pricing stock on hand; and an attempt will be made to indicate the extent to which each has legitimate application. In particular I wish to venture a criticism of the familiar rule, "cost or market, whichever is lower."

The acute stage in the inventory process is pricing or valuation, and it naturally appears after the sheets covering the physical inventory have been prepared. The question then arises: How shall these physical data be transmuted into value terms, into dollars and cents? The first step in its solution in any case would seem to be the adoption of a fundamental point of view, a basis or a starting-point from which to proceed. Among the welter of theories and practices, it seems to me that three main possibilities may be distinguished: (1) actual cost; (2) replacement cost; and (3) selling price. I shall consider each of these in turn.

II.

In the first place precisely what is the significance of actual cost as a basis for the valuation of merchandise on hand? Is it a satisfactory test of value, in view of the various purposes involved? Does actual cost furnish a reasonable foundation upon which to exhibit immediate financial position or from which to compute periodic net income?

Doubtless most of us would agree that actual cost, as an indication of financial condition on a specific date, is not an entirely satisfactory basis for valuation, even with respect to current assets. Price movements between purchase and inventory dates are quite likely to be so striking as to render cost a somewhat dubious representation of true economic standing. Cost may give either too high or too low a figure. But this objection to actual cost as a basis for inventory valuation is not decisive, especially in certain fields. The balance-sheet, it must be remembered, is bound to include figures that involve judgments to some degree. It is only ideally that this statement exhibits the true financial condition on a specific date. One might indeed go further and say that since present status in the ultimate sense is inevitably connected with future events no precise statistical representation of such status is even conceivable. At any rate cost of current goods on hand can hardly be given wholesale condemnation as a balance-sheet figure. This is particularly true in certain retail activities where selling prices respond slowly to new buying prices.

No doubt there is a grain of truth in the popular notion that the merchant, in the face of declining buying prices, will make a desperate effort to market stock on hand before seriously cutting selling prices. Similarly, in the case of an advance, goods are not always marked up until the old stock is largely worked out. In cases where lack of competition and general business inertia make this possible, actual cost evidently has a special validity as an expression of financial condition. Further, it should be noted that the inventory does not always constitute a very large percentage of the asset total; and in such circumstances any fairly reasonable scheme for valuing the inventory would not result in a serious distortion of balance-sheet figures. Still further, it should not be forgotten that the balance-sheet is usually prepared as an exhibit of going-concern values rather than liquidation values. This last point requires a word of emphasis. In general—and notwith-

standing statements by accountants and textbooks on auditing to the contrary—the balance-sheet is not prepared for the sole purpose of presenting it to a banker from whom the management is seeking a loan. It is a statement designed primarily for the guidance of the immediate management and the information of the investor; and rules of valuation for balance-sheet purposes should be adopted with this in mind.

Let us turn now to a consideration of the propriety of the actual cost basis for valuing inventory with reference to its effect upon the income sheet. From this standpoint actual cost has one very substantial argument in its favor: it is the only valuation plan by which the computation of income may be restricted exclusively to sale transactions. In other words, it is the only basis for the valuation of inventories which is consistent with the use of the sale as the exclusive criterion of revenue. That is, the accountant who insists that the sale is the proper evidence of income cannot reasonably support any basis for the valuation of inventories other than actual literal cost. This argument, of course, is especially important in the trading field. In the nature of the case, selling is the dominant activity of the wholesaler, retailer or other trader. Is not the sale, then, the best gauge of income in this field? Is not the sale the significant, climactic transaction for the merchant? Some rational, systematic plan for the periodic calculation of income is needed; and in this field it would seem that the succession of sale events furnishes a guide to the income conclusion that may well be rigidly followed. Especially is there reason for this position in view of the fact that in the case of the trader the importance of the closing inventory as an element in the computation of a rational income figure may be said to outweigh its significance as an evidence of present value for balance-sheet purposes.

But even if we assume that actual cost is a satisfactory general basis for the valuation of goods on hand under certain conditions there remains the problem of the concrete application of this principle. Here serious, indeed well-nigh insurmountable, technical difficulties are discovered at once. Unless all the goods on hand in a given case have been acquired at a single cost price—a condition seldom realized for the yearly period, especially if the influence of the initial inventory be considered—the actual cost of the stock at the end of the accounting period can only be determined where it is possible to identify every individual item of

the inventory in terms of particular shipments and lots acquired and the invoices attaching thereto. In other words, this basis for pricing goods on hand cannot be literally applied in practice unless it is feasible by means of a system of marking, storing or otherwise to preserve the actual cost of every unit.

In a great many cases, it is perhaps needless to say, this is impossible or inexpedient. The manufacturer, for example, who buys hundreds or even thousands of classes of materials and supplies at varying prices and in perhaps still more numerous lots finds it almost out of the question to discover the actual cost of goods on hand at a particular time; and the trader very frequently finds himself in a like position. Indeed, the precise determination of the actual cost of the inventory following a period of severe price fluctuations would be an exceedingly tedious and expensive task even in the most favorable circumstances.

As a result of this situation all sorts of expedients are adopted in practice. I think I am safe in saying that more frequently than otherwise the inventory at cost, so-called, scarcely approximates actual, literal cost. An investigation of inventory practices undertaken some time ago by the income-tax unit disclosed the fact that although many taxpayers nominally prepare inventories on a cost basis this does not indicate the use of any one distinct principle. A so-called "cost" inventory may be the result of any one of numerous interpretations, schemes and devices. Often the figure used is simply a guess, an intuitional cost, prepared by an owner or manager who is relying upon his general impressions and experience. More or less arbitrary adjustments are common. If the preliminary calculation does not result in a figure which quite suits the fancy of some officer who has a weather-eye open for the amount of the federal-tax obligation, for example, a revision may be instituted based upon some other method or rule which results in a paring off of perhaps many thousands of dollars, the concluding figure, nevertheless, being labeled "cost."

"Let's put this stuff in at forty cents," says the owner or other person in charge. Thus the problem is too often solved. By sheer accident an amount in the neighborhood of actual cost may be fixed in this manner. It is more probable, however, that a serious element of error will be involved. Especially is this likely to be the case if the inventory is composed of remnants of many lots, acquired at a considerable range of prices, and includes some stock

which has been carried over from preceding periods. A mere estimate, in such circumstances, will probably be so strongly tinctured by impressions derived from current quotations as to give a quite inaccurate representation of actual cost.

III.

Let us now turn for a few moments to a consideration of some of the more or less systematic devices and expedients designed to discover approximate cost (some reasonable substitute for actual cost) which are found in practice.

First may be mentioned the arithmetical average of invoice prices. The use of such a value, in lieu of actual cost, is by no means uncommon. In some cases this substitute figure is rather carefully worked out by making use of the prices of all lots purchased during the period, with the price used in valuing the last preceding inventory included. In other cases the calculation is restricted to the prices of purchases for the period. In others the prices of a few supposedly representative lots are averaged. In some instances the computation is so carelessly handled that the result is again little more than an estimate. However the calculation is made, all such interpretations of actual cost can be criticized on the ground that they ignore the variation in the amounts of the different shipments received and hence are almost sure to contain a dangerous element of error. In other words, they are based upon the assumption that all lots acquired currently are of the same amount and that the initial inventory—if its influence is recognized at all—is just the equivalent of one of these equal lots. This is evidently quite contrary to the actual facts.

This brings us to a second device or, rather, group of devices. In many cases a cost figure to be applied to stock on hand is worked out by some sort of a weighted-average method. The most reasonable of these schemes involves a combination of initial inventory and total purchases with respect to both quantity and value. It is sometimes worked out by having both quantity and value columns on the ledger page. The periodic value total divided by the quantity total gives the weighted average cost per unit to be applied to the quantity on hand in determining the inventory value. This plan is based upon the assumption that the goods utilized, consigned or sold are taken from the various lots received in exact proportion to the initial amounts of these lots or,

in other words, that goods on hand are composed of the different shipments acquired (including the initial inventory as the first lot) in proportion to the quantities thereof; and its accuracy as a device for calculating actual cost evidently depends upon the degree of validity attaching to these hypotheses. As a matter of fact we know that this postulate is quite unsupported by actual conditions in a great majority of cases. Goods are not utilized nor sold in precise proportion to the quantities in the various lots received. Indeed, a movement of goods in exact conformity with this assumption would be virtually impossible, as it would mean, strictly speaking, that no shipment or lot could ever be completely exhausted or closed out. Such a situation would be somewhat analogous to the pancake-batter jar in the college boarding house: at least a trace of all preceding lots is included in each inventory.

There are many variations of this plan. In some cases a weighted average with respect to a few large lots is taken. In others the effect of the initial inventory is ignored, and the calculation is confined to current acquisitions. The so-called "moving" average has been advocated and has been employed in some cases. This device involves the use of a period for the cost computation which is not conterminous with the current accounting period, and both very long and very short periods have been proposed.

The base-cost scheme of pricing, strongly urged by several large corporations and definitely repudiated by the income-tax unit, gives a kind of long-term or standard cost. An officer of one company argued that the proper cost to be employed in valuing the minimum or "cushion" inventory of standard raw materials was a normal cost determined by taking a rough average of prices over a period of twenty years or more. In other cases the average price for the two or three years immediately preceding the war period was urged as the cost which should be applied to the standard volume of inventory. All such schemes have been disallowed by the bureau of internal revenue. Even the systematic weighted-average method, it may be noted, has been once rejected as a general device for tax purposes, although a later ruling gave the tobacco companies permission to continue their use of this method and it is quite probable that it may be given a broader endorsement under the more liberal terms of article 1583 of regulations 62, recently issued.

Another plan for the determination of an inventory value on a cost basis—a plan which has been widely adopted and is endorsed by the treasury department for use in cases where it is not feasible to discover actual literal cost—is based upon the assumption that goods utilized or sold are always taken from the oldest in stock or, in other words, that the goods on hand consist of the most recently acquired lots. To ascertain inventory value by this method it would be necessary simply to arrange invoices in a chronological sequence and, beginning with the latest, take off both quantity and value figures until a quantity total equivalent to the physical inventory had been obtained. The corresponding value total would constitute the value inventory. (In most cases, of course, it would be necessary to divide the amounts of one invoice and include only the appropriate parts.) If recent purchases had been at all heavy this would commonly mean that the invoices of only a few weeks would need to be examined to obtain the inventory figure. In some cases it would mean the use of essentially the latest cost. Where the turnover rate was low, recent purchases light and price fluctuations substantial, on the other hand, the inventory value resulting from this plan would bear little relationship to current values.

It is clear that such a valuation procedure will not ordinarily give results which jibe with the actual physical facts. Goods consumed or sold are often taken from new stock rather than old; and probably in no case does withdrawal follow order of receipt exactly. Yet this plan is strongly supported by economic principles. Unquestionably it is only relatively recent prices that are of any interest to the immediate management. In general the only cost exercising any marked effect upon selling price in a competitive market is the immediately potential cost. Hence a principle of valuation which gives results which are not widely inconsistent with current market conditions is much to be desired.

This method of pricing inventory deserves serious consideration by business managements and accountants. It may be recommended for three principal reasons. First, by this means the inventory value is drawn from the actual records in a simple and systematic way, all guessing and uncertainty being eliminated. Second, as already stated the method is at least roughly in harmony with sound economic and business principles in that the inventory value so derived is commonly a fair representation of cur-

rent commercial values. Third, it is based upon a definite and rational assumption with respect to the movement of goods through the business enterprise, an assumption which might well be validated as closely as possible as a matter of good business. (In other words, in general it would pay the merchant to close out the older stock first.)

With this brief statement of the common interpretations of cost as a basis we may now appraise the validity of this general principle of valuing inventory. In the first place, it should be roundly emphasized that actual, literal cost has a limited application in practice and that most "cost" inventories, so-called, are based upon cost in a mainly nominal sense. In the second place, it must be remembered that the various schemes and devices employed are almost certain to give quite divergent results. In other words, "cost" inventories in practice are far from homogeneous; the nature of the amount finally obtained in any case will depend essentially upon the method used to obtain cost. In these circumstances it would seem reasonable to conclude that actual cost is a fairly satisfactory basis for valuing inventories in the trading field, provided it is feasible, by means of price marks or some other system of identification, to ascertain this value. Further, where it is not expedient to determine actual cost the most satisfactory substitute is the cost of the most recent acquisitions up to the amount of the physical inventory. In view of the fact that the task of pricing an inventory on an actual cost basis is likely to be very tedious in any case one might urge, as a practical matter, that this substitute is to be preferred even where it is possible to determine actual cost.

IV.

Replacement cost is the second main basis for the valuation of inventories which was mentioned above. This principle of valuation, I believe, deserves more favorable consideration than it has thus far received. It is not a strictly orthodox principle, many accountants considering it to be quite unsound from a practical standpoint. The main objection seems to be that the consistent use of replacement cost as a basis for inventory valuation is bound to mean—in a period of rising prices—the recognition of income prior to actual sale—unrealized profit, so-called. It should be insisted, however, that this single objection does not justify a complete repudiation of replacement cost as a useful valuation expe-

dient. Business conditions are highly complex and varied; and there are some situations in which this basis for valuation is distinctly applicable. It seems to me that the proposition that such a scheme may involve the recognition of a minor income element is largely pointless. This objection, so often urged by accountants, is an illustration of the fact that supposedly practical men are often prone to out-theorize the academicians. The inventory is only one element in the income calculation; some consistent and reasonable plan for valuing it must be worked out; the use of replacement cost in certain cases would not mean the repudiation of the sale as the primary income transaction.

Three principal points may be urged in support of this theory of valuation as applied to inventories. First, it is more logical than the actual-cost plan—or most of the proposed substitutes therefor—since it avoids attaching different prices to identical goods existing concurrently in a particular situation, and thus does not violate the law of single price. Second, it conforms exactly to the theory already mentioned that replacement cost is the only cost having significant effect upon selling prices in the long run and hence is the only cost having real meaning for the management. Third, it can be put into effect with a minimum of clerical effort; it gives the simplest possible method of pricing the inventory. A fourth important reason might be added, namely, that replacement cost is undoubtedly the most satisfactory evidence of financial condition for balance-sheet purposes.

Of these arguments the second and third are doubtless the more important. In all business situations in which selling prices move freely in response to changing cost prices—and this is especially true in wholesaling and in certain manufacturing—values based upon current costs are certainly more significant to the management than values which represent actual costs, provided, of course, that the two happen to be markedly divergent. In such circumstances replacement cost undoubtedly is the best expression of the significance of the inventory from the operating standpoint; it gives the more reasonable indication of the effective working capital tied up in the inventory. Consequently more rational conclusions may be drawn from current replacement costs than from earlier cost figures in planning production and sales policies. There is a good deal of evidence that even in retailing selling prices fluctuate in closer conformity to current replacement costs than

popular opinion admits. In many lines any material reduction in wholesale prices forces an immediate and more or less corresponding drop in retail prices; and an advance in wholesale prices, similarly, results in an immediate mark-up by the retailer.

From a practical standpoint, however, the simplicity of replacement cost as a basis for pricing inventory is probably the principal advantage inhering in this plan. Replacement cost, as a rule, is a definite and unmistakable figure. One cannot honestly give it all sorts of interpretations. The latest trustworthy quotation from the regular source of supply in terms of the quantities usually purchased is the proper replacement cost to use. Multiplying this price with the physical inventory gives the value inventory. Compare this process with that which involves the listing of virtually every item in every class throughout the entire inventory and the calculation of the grand total. It would seem reasonable to suggest that in the absence of fundamental and conclusive objections the saving of clerical labor alone would justify the adoption of replacement cost as opposed to actual cost.

This clerical simplicity is most marked, of course, with standard merchandise, materials and supplies. To determine the cost of replacement of semi-finished or completed goods in the hands of the fabricator is more troublesome. As far as the materials element is concerned, the replacement cost of work in process or finished stock can be readily calculated by applying the latest standard quotations to physical quantities determined from specifications or otherwise. The materials replacement cost of such goods, indeed, can be ascertained far more readily than the actual cost in materials because of the difficulty already mentioned of identifying materials put in process in terms of specific invoices. Labor cost of replacement could also be readily ascertained if the subsidiary records required to determine actual cost were available. With respect to overhead or burden, however, the task would be more difficult and would, at certain points, involve rather fantastic ideas and procedures. The plant and equipment depreciation element in burden, for example, could be calculated from a cost of replacement standpoint only on the basis of an estimated cost of replacing these fixed assets themselves. Perhaps this would give an ideal valuation; but most of us would agree that it would be impracticable in any case to push the application of replacement cost figures to this extreme.

It should be noted that the use of replacement cost would commonly not give results markedly divergent from those obtained by using cost interpreted as the cost of the most recent acquisitions up to the amount of the inventory. This point is worthy of a sharp emphasis in view of the enthusiasm with which some accountants reject replacement cost as a legitimate valuation principle and yet are quite ready to accept an interpretation of actual cost which amounts to about the same thing. The difference between these two methods is evidently largely nominal. One involves adherence to recent invoice records; the other consists of the application of the latest legitimate quotation. Usually the results of the two procedures will be roughly the same.

It may be urged that the accountant, in deference to current prejudices, should adopt the cost of the most recent purchases up to the amount of the inventory as a closing valuation rather than its more logical blood-brother, the cost of replacing the stock on hand; and there is little objection to this position. To a degree it is a matter of Tweedledum and Tweedledee. But the propriety of the other principle should also be admitted. Why need the advocacy of a qualified use of replacement cost be counted a heresy? In the case of standard raw materials and supplies in the hands of the manufacturer at least, the use of this rational and easily applied principle would seem to be highly sane and conservative. Here it is seldom feasible to discover exact cost. Further, since a more or less complex process intervenes between raw materials and sales of finished stock in the case of the manufacturer, a computation of income exclusively and precisely in terms of sales need not be insisted upon in such cases. It is clear, also, that replacement cost is a thoroughly sound basis for valuing the inventory of a dealer in securities, a fact which has just been recognized by the bureau of internal revenue in regulations 62.

V.

I wish now to discuss briefly the popular valuation expedient which is a combination of the two main principles which I have just examined. This is the use of actual cost or replacement cost, whichever is lower. This rule was sponsored as a universal valuation formula by a committee of accountants reporting to the British board of inland revenue in 1917; it has been adopted by our own bureau of internal revenue as one of two main alterna-

tives; it has been strongly if blindly supported in various textbooks, trade journals and other publications; and many professional accountants endorse it. Nevertheless, I believe that this valuation scheme is thoroughly unreasonable and should be discredited by accountants for reasons which are conclusive from both theoretical and practical points of view.

In the first place, the literal, precise application of this rule is almost impossible because of the clerical difficulties and amount of work required. Just think what the thing involves! To begin with, it means—if it is to be strictly interpreted—that the actual cost of each item on hand must first be determined. This, as has been indicated, is often an impossible or impracticable task in itself and in any case involves almost endless labor. Next the replacement cost of each class must be ascertained. This is more easily done; but it should be emphasized that such technical difficulties as do beset the cost of replacement method have all to be dealt with here. (This the opponents of the replacement-cost theory seem always to forget.) And in the case of work in process and finished stock, as was pointed out above, the computation of cost of replacement—especially with respect to the burden element—is by no means a simple task. Finally, the alternative figures for each of the perhaps hundreds or even thousands of classes in the inventory must be compared, the lower of the two must be selected in each case, and this collection of actual costs and replacement costs must be totaled to give the final inventory figure. A more involved and absurd method of pricing could hardly be invented.

Second, and perhaps more important, this rule violates one of the fundamental canons of sound accountancy, namely, consistency. Values ascertained in accordance with this scheme are a hodge-podge. This inconsistency is more serious than a casual examination of the question reveals. When we come to consider the concrete use of this rule in practice it is discovered that it cannot, in the very nature of the case, have much real application in the terms in which it is usually stated. This fact is due to the character of price movements in their effect upon the particular enterprise. In general the statement holds that the prices of virtually all classes of goods found in the particular inventory move in the same direction although perhaps not at the same rate. This means that if replacement cost is seriously below actual cost, for example, with respect to one important class of the inventory

it is very likely to be below cost for all other classes. What, then, must be the actual situation with respect to the use of this combination rule? The answer is clear. The merchant or other business man who is attempting to adhere to the "cost or market, whichever is lower" scheme is really merely vacillating from year to year between actual cost and replacement cost as bases for inventory valuation. In one year he uses actual cost; in the very next period, perhaps, he shifts to replacement cost, and so on. This, it seems clear, is the very antithesis of sound accounting! Surely no one can argue that this sort of valuation procedure results in a rational distribution of income between years!

In view of the treasury department's strong predilection for the proposition that each year must stand on its own bottom, and its explicit espousal of consistency in inventory practices, its admission of "cost or market, whichever is lower" as a valid valuation principle is almost incomprehensible. Consistency, it should be insisted, is probably the primary virtue to be observed in taking inventory (especially for tax purposes). Almost any fairly reasonable rule of valuation, if steadily adhered to, will result in at least a moderately satisfactory series of income and balance-sheet exhibits. It is the shifting from one basis to another that results in an unreasonable distribution of income between years. But to date the treasury department has made it rather easy for the taxpayer to jump from one expedient to another. Take the eleventh hour decisions made in December, 1920, for example, to the effect that any taxpayer could—regardless of his past practice—value his 1920 closing inventory (materials, work in process—including the burden element therein—or salable merchandise) for purposes of his tax return on the basis of the lowest of the three (1) actual cost, (2) replacement cost and (3) selling price (or the appropriate part thereof in the case of unfinished goods). This sort of thing is bound to encourage inconsistent inventory procedures. On the other hand, it should be noted that in the regulations 62 an encouragingly broad and sane attitude has been adopted by the government.

In the third place, the use of actual cost or replacement cost, whichever is lower, in valuing inventories does not insure the restriction of the income calculations to sale transactions; hence this device lacks the main virtue which most of its supporters seem to be attributing to it. It evidently permits the recognition of losses

unrealized by sale. Further, it allows the recognition of income unrealized by sale in cases where goods have been held for some time and replacement cost, while still below actual cost, has advanced beyond the initial inventory figure.

But, it may be objected, after all this rule is a counsel of conservatism, a valuable expedient in preventing income inflation, excessive dividends, etc. In answer to this I would say that it seems to me that conservatism in the best sense is never assured by inconsistent and unreasonable practices. It would be far more rational to take inventory consistently on either a cost or a cost of replacement basis, a part of the resulting income being ear-marked as a reserve not available for dividend declarations in any year in which this was deemed to be advisable. Conservatism does not demand arbitrary adjustments of legitimate values from the standpoint of the going business. The accountant is not invariably presenting statements of bankrupt concerns. To insist that inventory must be priced on the "cost or market, whichever is lower" plan is an admission of incompetence. Why not be consistently conservative? If the accounts receivable are doubtful, pare them to the bone; if any merchandise on hand is shopworn, obsolete or otherwise impaired, attach liquidation values. But in the case of a live stock in the hands of a sound business enterprise why is it necessary to adopt an arbitrary expedient which violates logic and fundamental canons of good practice?

These considerations (which might, of course, be greatly elaborated) warrant the conclusion, I believe, that the "cost or replacement cost, whichever is lower" rule has no legitimate application in any situation in practice and should certainly be discounted by the public accounting profession.

VI.

The final valuation base mentioned at the beginning of this paper is selling price. Selling value may be used in the inventory in two quite different ways. In the first place this value may be taken as a starting-point in calculating an inventory in terms of what is usually conceded to be a kind of cost value. The treasury department, for example, in T. D. 3058 (incorporated substantially in regulations 62) authorized retail dry-goods dealers to value inventory by means of the so-called retail-price method, a plan which consists essentially of computing cost of stock by de-

ducting a purchase-mark-up percentage from the selling value of goods on hand at the date of the inventory. Manufacturers sometimes make use of the general relationship between periodic burden and sales in computing the burden-cost element in work in process and finished stock. Selling price is also employed as the best starting point available in certain cases where satisfactory costing for labor and materials is impossible or inexpedient. A large manufacturer of pharmaceutical supplies, for example, who uses hundreds of classes of raw materials and turns out over a thousand distinct products, has for years valued inventory of work in process and finished stock by means of a formula designed to reduce selling value by estimated costs yet to be incurred plus estimated profit. The resulting figure is either cost or more or less than cost, depending upon the accuracy with which the estimated profit measures the difference between selling price and actual cost (or what, in the case of incompleted work, will prove to be actual cost). In the case where list selling prices had been recently advanced and the profit percentage used was based on earlier experience, the inventory value so computed would be likely to express cost of replacement more closely than actual cost.

The other possible use of selling price as an inventory base is its direct application to goods on hand—adjustment having been made, of course, for costs yet to be incurred—to obtain the value of the inventory. This rule of valuation is, in general, the accountant's pet aversion because it is held to involve the recognition of anticipated income—unrealized income in the most extreme form. Yet it should be emphasized that any sweeping denunciation of this principle is unwarranted. It has a recognized application in certain fields, and it is quite possible that it should be extended somewhat further. We commonly admit the propriety of this rule in the case of finished goods made to order on a binding contract, and in cases where the fabrication process is peculiarly long—shipbuilding, for example. Further, the treasury department, in permitting farmers to value unsold produce at sales price less estimated marketing costs has recognized its validity in another special situation. It might also be added that the valuation of securities at the market can be interpreted as involving the use of selling price, since replacement cost and selling value are here virtually identical.

In general, a rather strong argument may be made in support of adjusted selling value as a basis for inventory valuation in all cases where the selling activity is a minor incident of the production process requiring no special effort or expense to be taken for granted. These conditions clearly obtain in the case of the inventories of gold producers, to a degree in other mining and to some extent in oil production and other extractive industries. With respect to all staple products from these fields sale is assured without much effort at the going price. It is not necessary to advertise, to maintain an extensive selling organization. Production rather than sale is the activity to which all effort is directed. Hence it is not unreasonable to value inventories in such a way as to involve a calculation of income partly in terms of technical completion.

A farmer, for example, has 5,000 bushels of wheat in his bins. What is its reasonable inventory value? Selling price less marketing costs would seem to be the simplest and most valid basis. Sale is assured; no salesmen or selling efforts are required. Whenever the farmer wants to market his wheat he simply loads up and drives to the nearest elevator. Further, even if it were feasible for the farmer to determine specific costs—a well-nigh impossible task on any reasonable basis—it should be emphasized that such costs would not represent a very satisfactory inventory value for unsold produce. Whether the specific farmer's cost is high or low it will not have the slightest effect upon the value of his wheat. The price he will get is determined by a multiplicity of factors in a world market, the immediately determining element in this case being the forces of demand. The influence of specific cost upon market value in the particular season is nil; hence cost in such a case is of minor significance as an inventory principle.

Finally, in the case of farming and in some other extractive industries, buying price and selling price—as far as the producer is concerned—are roughly identical. In other words there is only one market which furnishes a fair test of value here. The position of the retailer who intervenes between two distinct markets is quite different. Thus selling value has an added significance for the farmer or other extractor.

In concluding these more or less incoherent comments on a very broad and difficult subject I would like to emphasize a few general considerations. In the first place we surely agree that

business conditions are so varied and complex that no single valuation rule or principle can be relied upon for application to every case. Instead, what are needed are many rules, principles and methods of procedure, each of which has a particular scope because of its propriety in a particular type of situation. We must take a broadminded attitude, condemning no rule or principle purely on the basis of tradition and prejudice, but testing every method primarily on the grounds of reasonableness and expediency. Further, because of the muddle in which the valuation problem stands at present, accountants owe it to themselves and to the interests they serve to devote their best efforts to the development and formulation of valuation devices and methods of procedure suitable in the various fields of business.

In the second place it is submitted that the three principal bases which should be used as starting points in inventory valuation work are actual costs, replacement cost and selling price. It should be recognized that each of these has its place and must not be discarded in any summary fashion. It should be further recognized that exact literal cost, because of the clerical difficulties involved in its employment (and for other reasons given above) should in general give way either to (1) cost interpreted as the cost of the most recent acquisitions up to the amount of the inventory or (2) outright replacement cost.

Finally, I would like to reiterate my conviction that the "cost or market, whichever is lower," device is thoroughly unreasonable from the practical standpoint and has no place in any scheme of scientific accounting. I sincerely hope that the American Institute of Accountants, which in its refusal to endorse the inclusion of interest on investment as a cost and in other matters has always exhibited a steadfast loyalty to sound accounting principles, will use its influence to discourage the use of this unsound rule for inventory valuation.

The JOURNAL of ACCOUNTANCY

Official organ of the AMERICAN INSTITUTE OF ACCOUNTANTS

A. P. RICHARDSON, *Editor*

EDITORIAL

Education or Advertising

Most of the readers of THE JOURNAL OF ACCOUNTANCY—certainly all those who are members of the American Institute of Accountants—are aware that the institute, after consideration lasting several years, has now gone on record as opposed to all forms of professional advertisement of the individual's abilities, facilities and desire to undertake accounting work, and that at the last meeting of the institute a resolution was adopted approving a rule of conduct expressive of this determination.

Since publication of the rule which appeared in the October issue of THE JOURNAL OF ACCOUNTANCY, we have received a considerable amount of correspondence on the subject, and, as was to have been expected, the writers have given utterance to opinions on both sides of the question. We are not, however, directly concerned with discussing a matter which has been definitely decided. The policy of this magazine for many years has been directed to an education of the accountant and the general public to the thought that professional advertising in its personal application is and must be unethical.

One of the letters which we have received is, however, of more than passing interest, and portions of the correspondence with the writer of this letter are worthy of publication.

Incidentally, it may be mentioned that the correspondent firm does not consist of members of the institute, but of practising public accountants who are anxious—as we believe all reputable practitioners are—to observe the standards enunciated by the institute.

Shortly after publication of the October issue we received a letter containing the following paragraphs:—

“We have read with a great deal of interest the *Restriction of Advertising* editorial appearing in the October number of THE JOURNAL.

"We have never solicited any business from any one, and have confined our advertising in all newspapers and other publications to a card, with the exception of our card appearing on our monthly bulletin on taxation and business. We are forwarding you copy of our July number, and ask that you notice our advertisement, and advise us if this is contrary to the rule of the Institute, as we desire to adapt our procedure in all instances in accordance with the ethical interpretation of THE JOURNAL and the American Institute of Accountants."

In the hope of obtaining an expression of opinion from the highest authority on the subject, this letter was referred to the chairman of the committee on professional ethics of the American Institute of Accountants, who replied to the correspondent as follows:

"Your letter of October 10th addressed to THE JOURNAL OF ACCOUNTANCY was sent to me as chairman of the committee on professional ethics of the American Institute of Accountants for reply.

"Doubtless you are informed about the considerations and the discussion which, after many years, led to the adoption of the rule to which you refer. While you may have a lively appreciation of the abuses which led to the adoption of this rule, you may not have so lively an appreciation of the difficulty of finding language in which to formulate a rule intended to prohibit unethical practices and at the same time permit practices which in themselves may be unobjectionable.

"Until a larger experience is at hand the chairman of the committee is loath to make such specific and concrete reply to your question as is called for when you submit your monthly bulletin and ask: 'Does this particular document come within the inhibition of the rule?' My present personal opinion (not official opinion) is that a specific answer would largely depend upon the circumstances surrounding the circulation of this document. Were it used solely 'for the proper and professional dissemination of impersonal information among a member's own clients or personal associates' the answer might be that it was not objectionable and not prohibited by rule 12 of the rules of professional conduct. If, however, the circulation of this bulletin were made the vehicle for promiscuous advertising publicity, it would, in my opinion, come within the prohibition of the rule.

"After all, professional ethics is not a thing that is altogether capable of literal definition, but, as some one very aptly said, it is rather a state of mind."

The response to the foregoing letter is noteworthy:

"Thank you for your letter of October 20th replying to letter of October 10th in which was submitted copy of a bulletin circulated by my firm.

"The question submitted being:

'Does this particular document come within the inhibition of the rule' (Rule 12).

"You have expressed my views, 'Professional ethics is rather a state of mind.' May I add, that provided the mind is controlled by a man who is fundamentally a gentleman.

"The bulletin referred to is distributed only to our clients and the Association yet on the other hand the object back of

the thing was advertising publicity, but not 'promiscuous advertising publicity.'

"In accordance with your personal views this bulletin will be discontinued as soon as our contract with the printers expires.

"Thank you for your personal views which are accepted as a standard. I wish they would be accepted by all accountants in this part of the country, including the members of the institute located in this state."

One of the first points that appeals to us in the letter last quoted is the prompt acquiescence of the correspondent in what was merely a suggestion of the chairman of the committee on professional ethics. If anything were required to demonstrate the influence of the ideals of the institute it would be supplied by this recognition of the excellence of the institute's standards.

The second point is the very faintly veiled inference that some members of the institute do not at all times observe the canons of professional ethics. To this, of course, those who are familiar with the facts cannot present a complete denial. We believe that there are several members of the institute who have been and probably continue to be ready to take advantage of a literal interpretation of rules by which without infringing the strict letter of the law they depart widely from the spirit of it. These things must be admitted in view of the repeated assertion of correspondents and others that ethics—we were about to say vary, but of course ethics in a profession do not vary—are differently interpreted by individuals.

And this brings us to the point which we desire to express to that portion of the public to which this magazine is carried.

For about two years past the American Institute of Accountants carefully and quite thoroughly considered the desirability or otherwise of undertaking a nation-wide campaign of what has been called advertising, publicity, propaganda, educational effort and half a dozen other generic terms, all of which have the possibility of objectionable connotation. Various plans have been suggested for expressing in the most conservative and unobjectionable way the purposes and accomplishments of the public accountant in the United States of America. The matter is still in the hands of a committee, and some sort of general plan may or may not be adopted.

It seems to us, however, that there is an opportunity to accomplish a great result and lasting benefit if the institute by some means can contrive to educate the accounting profession,

whether members of the institute or not, to the spirit which animates the organization and is responsible for the laying down of the twelve rules of conduct which have been adopted. This spirit, differently expressed, finds voice in the splendid educational efforts which have been made by some of the leaders of the profession through the endowment fund (now known as the American Institute of Accountants Foundation). We do not profess to understand why, but we are aware that many accountants who are proud of their membership in the institute are not fully informed of the things which the institute has done, is doing and intends to do, although these things have been impressed upon them as far as possible by both written and spoken advice.

It seems to us that a great opportunity is open to the institute primarily to educate its own members; secondarily, the rest of the profession; thirdly, the general public; and whether a concrete and definite campaign of publicity, or whatever name may be applied to it, be undertaken or not, there is no doubt whatever that further attempt should be made to bring to the attention and consideration of all members the impelling force behind the great movements in which the institute is interested.

With the broad vision which has been manifest from the beginning of the institute's activities and with the assurance of continued interest by those who take the larger view, it may confidently be predicted that the institute will labor steadily and effectively for the betterment of the profession, for more adequate preparation of those who are to be public accountants and, directly and indirectly, for a higher plane upon which American business and professional relations shall be conducted.

What is needed further is to bring home to the accountants themselves what they are, what they may be and what part the institute is playing in the grand scheme of things entire.

Income-tax Department

EDITED BY STEPHEN G. RUSK

Our attention has been arrested on numerous occasions of late by the interest that is being evinced by certain individuals and newspapers as to the administration by the treasury department of the provisions of section 220 of the revenue act of 1921.

This section, it will be remembered, imposes an additional tax of 25% upon income of corporations which permit the accumulation of gains and profits beyond the reasonable needs of their business in order to prevent the levying of the surtaxes upon their stockholders. It gives the stockholders the option of being taxed upon their proportion of the earnings though undistributed, in lieu of the specific additional tax above mentioned. Former revenue acts have had provisions of a similar nature but undoubtedly have been found unenforceable, at least we have heard of very little action toward the collection of these taxes.

It appears from the language of the section that a corporation will be subjected to this tax if there is evidence that it was formed or availed of for the purpose of preventing the imposition of the surtax upon its stockholders. *Prima facie* evidence of such purpose is the fact that it is a mere holding company, or that gains or profits are permitted to accumulate beyond the reasonable needs of the business.

One can foresee the difficulties the administrative officials will have in imposing this tax, and the elaborate statistics that will be prepared by the department in order to prove that the accumulated gains are beyond the reasonable needs of the business. When consideration is given to the power this section of the law places in the hands of the government and the extent to which it takes out of private control the management of the fiscal policies of corporations, it seems highly probable that upon a test being made it will be found impracticable if not unconstitutional.

In view of the general business conditions now being faced by corporate management, with the uncertainties of the future to face and the need of conserving its resources it will be difficult for the government to prove the unreasonableness of the amount of the accumulation in the majority of cases.

The treasury department is being urged to action upon this particular tax provision, and question is being raised as to stock dividends declared as if the declarations of stock dividends were made to forestall the imposition of this tax.

As to the avoidance of tax under this section by the declaration of a stock dividend, we are of the opinion that as a stock dividend has been held not to be a distribution of gains and profits, the declaration and payment of such a dividend will not prevent the imposition of the tax under this section. The fact that unreasonable accumulations of gains and profits have been capitalized by the issuance of stock certificates to represent them, obviously would not prevent the functioning of this section and those advancing this theory do not seem to have taken account of the language and intent of these provisions.

Question has been raised as to the effective date of this section. Some maintain that it is November 23, 1921, the date of the signing of the revenue act. Some maintain that its effective date is January 1, 1921, the date the other taxing sections became effective. We believe there is some question as to which of these dates is the right one, though we have thought November 23, 1921, is the effective date.

Opinions of our readers are solicited upon the provisions of this section of the law.

(On account of extreme pressure on space in this issue we omit publication of any treasury rulings.)

Students' Department

EDITED BY H. A. FINNEY.

FEDERAL TAXES AND EMPLOYEE'S BONUS.

When an employee is allowed a bonus based on the net profits, the question whether or not federal taxes are to be considered an expense to be deducted before determining the net profits subject to the bonus should be considered at the time of making the contract, and a provision dealing with that question should be inserted in the contract. If such a clause is not inserted in the contract the question will come up when the bonus is to be computed; the company will claim that the tax should be deducted as an expense, the employee will claim that the tax should not be deducted, and the dispute will be on.

The dispute may be arbitrarily settled, compromised or referred to some one for arbitration. So far as I know, the person who arbitrates the dispute will have to decide the question on the basis of his own opinion. At least, I know of no legal ruling which can be considered absolute and final authority. If there is such a ruling I hope that some one who reads this will know about it and will refer me to it so that the information can be published in a subsequent issue.

In the July, 1922, *Students' Department*, the question of taxes and bonus was put by a reader as follows:

Editor, Students' Department:

Sir: "A" was the manager of several departments in a store and had an oral agreement with the president that in addition to his salary he was to get 10% of the profit of those departments. No data are available to show if there was any other qualifying condition as to how the profit was to be figured. Now the corporation submits him a statement giving the results of the year's business and in this statement his departments have been charged with a proportion of income tax paid to the government. Now the question in my mind is whether this tax paid to the government is a fair charge against his departments or if it is proper to charge it against surplus, pure and simple. Just what would be the correct way to treat this item, and what is the usual way of handling it?

Very truly yours,

G. J. P.

Walla Walla, Washington.

The published reply to this letter was:

"A is to receive a percentage of the net profits; the net profits are not known until all expenses have been deducted; taxes are an expense; therefore it is the opinion of this department that it is proper to deduct a portion of the income tax from the profits of the departments in which the manager was interested. The mere fact that the expense of taxes is computed on the basis of profits before deducting taxes does not change the fact that the taxes are an expense.

"Since the tax is based on profits, the proper way to apportion the tax among the several departments is on the basis of the profits of the departments."

This letter and the reply to it, brought a letter from C. F. Seeger, of Atlanta, Georgia, expressing a disagreement with the opinion stated. Before quoting the correspondence with Mr. Seeger I should like to elaborate the theory underlying my opinion.

Either the income tax is an expense or it is a division of profits. If it is an expense it is deductible in determining the net profit; if it is a division of profits it is not deductible. Which is it?

First, is it a division of profit? The word "profit" is defined in Webster's dictionary as "the advantage or gain resulting to the owner of capital from its employment in any undertaking," and this definition is in accord with the business conception of profits. Profits belong to the proprietor, partners or stockholders, and only the owners share in the distribution of profits. Taxes may be based on profits or, as is actually the case, on a concept of the law known as taxable net income; but the taxes paid to the government are not a distribution of the profits of the business, because the government is not a stockholder. The tax is a payment made by the business to the government for governmental benefits. Since it is a payment by the business for benefits received by the business it is an expense, and the profits of the business are not known until expenses have all been deducted and gross profits reduced to the figure remaining for distribution among the stockholders.

Incidentally, it may be noted that this reasoning can be applied with equal force to support an argument that the bonus itself should be considered an expense before determining the profits subject to the bonus; in other words that the computation of the bonus should be made by dividing by 100% plus the bonus rate instead of multiplying by the bonus rate. But this is not the point at issue here.

The question and answer quoted above, brought the following letter from Mr. Seeger:

Editor, Students' Department:

Sir: On page 65 of the July issue a question in reference to the effect of federal taxes upon bonus is considered, and I note that you take the position that federal taxes are an expense and therefore deductible in determining the manager's bonus under the agreement set forth in the question.

If my memory serves me correctly in several decisions the courts have criticized very harshly any attempt to consider federal taxes based upon profits as an expense. The writer concurs with you to the extent of the accounting theory involved, but it is possible to view the position taken by the federal courts that under the contract outlined in the question the manager was legally entitled to his bonus based upon the profits without regard to the amount of federal taxes paid.

Unquestionably there are many legal phases of the federal tax laws which run contrary to good accounting principles; nevertheless we must observe court rulings when any contract is in dispute. Irrespective of what we may think or believe, good accounting requires a strict compliance with the legal status of a contract and the best we can do when the legal status conflicts with our theory is to disregard the theory and comply with the construction which would probably be placed upon a contract by the courts.

I am not unmindful of the fact that court decisions with respect to individual contracts cannot be determined in advance of a suit. Of course based upon stipulated facts it is frequently possible for attorneys to agree

as to the legal situation, and while I may be entirely wrong I am inclined to believe, assuming the facts to be stated correctly in the question referred to, that a legal opinion would require the calculation of the bonus upon the profits without considering the federal tax even though it may not be equitable.

Yours very truly,

C. F. SEEGER.

The following reply was written to this letter:

DEAR SIR: It seems to me that it is pertinent to inquire the purpose of the cases in which decisions were rendered disallowing taxes as an expense. Was the point at issue the determination of net profits or taxable net income? There is of course no question that taxes can not be deducted in determining income subject to federal taxes, but I do not think that a court decision ruling out an item as an expense in determining taxable net income would necessarily be considered a precedent in a case brought to decide whether that item should be considered an expense in determining net profits subject to a bonus. That is why I should like to know just what point was at issue in the cases.

The point is an important one. If I was wrong in my opinion as expressed in the July issue, I certainly want to correct it. But whether or not I was wrong depends upon the nature of the cases in which federal taxes were held to be non-deductible. If the cases referred to in your letter were tax cases where the amount of taxable net income was at issue, I do not think that the decisions have any bearing on the question. If the cases were brought to settle a point on profits, aside from taxes, then they have a bearing.

If you care to look further into this and report on the character of the cases, and if you find that there are cases in which taxes were disallowed in computing net profit as distinguished from taxable profit, I shall be glad to give some space in a future issue to your findings.

Yours truly,

The importance of noting the nature of the point at issue in decided cases may be brought out as follows: Assume that action is brought by creditors of a corporation to prove that dividends have been paid in excess of profits, and that creditors are therefore entitled to recovery. It can scarcely be believed that the defense would admit that dividends had been paid in excess of net profits remaining after the payment of federal taxes, but not in excess of profits before the payment of federal taxes, and hence that the dividends did not exceed the profits. The rule that federal taxes are not deductible in computing taxable net income has no bearing on the ascertainment of profits available for dividends. Nor does the editor of this department believe that it has any bearing on the ascertainment of profits subject to a bonus.

To the letter printed above, Mr. Seeger replied as follows:

Editor, Students' Department:

SIR: Naturally the case or cases which I recalled related to the determination of net income for income and excess-profits tax purposes with the exception of one mentioned in Montgomery's *Income Tax Procedure*, 1918, page 302, paragraph headed "Decision Under British Act." Mr.

Montgomery states, "A decision . . . illustrates the point that income taxes are not an expense." I desire to also call your attention to page 301 of the same book on which will be found the following: "If the 50% now set apart as the government's share could be treated as an expense . . . it would produce an illogical result."

I next call your attention to page 2009, 1-30-22, paragraph 2033, in Prentice-Hall *Federal Tax Service*, volume 1, 1922, "Profit Sharing Contracts.—It is not unusual for the compensation of an employee to be contingent upon the amount of profits of the business or of a given department of the business. Unfortunately a great majority of the contracts providing for contingent compensation are so worded as to raise the question as to whether the compensation is to be based on the profits before or after the deductions of the federal income and excess-profits tax. The interpretation of a given contract depends, of course, upon its wording and the surrounding circumstances."

One can hardly conceive of an employee with the ability to manage several departments and earn a considerable bonus based upon profits being foolhardy enough to take legal issue with his employers over the matter of the deductibility of the tax in the determination of the amount of the bonus. However, it seems to me in view of the citations which I have made above from Montgomery and Prentice-Hall that considering the problem exactly as worded you can hardly afford to take the positive stand that has been taken in the *Students' Department* in determining the issue.

I disagree with you as to the relevancy that the construction which the courts place upon the tax laws in determining net income in disputed tax cases may have upon a question such as the one at issue. There may be some question with regard to the construction to be placed upon the meaning of net income as compared with profit but both Holmes and Black agree with the following quotation from Black's fourth edition of *Income and Other Federal Taxes*, page 36, paragraph 30, second sentence, namely, "All the acts of congress . . . have associated together the words 'gains,' 'profits' and 'income' as descriptive of the subject taxed."

In view of the foregoing I hold to the idea that income tax is in no sense an expense of business but a share of the profits seized by or belonging to the government under due process of law; consequently under the arrangements outlined in the problem the firm agreed to pay the manager 10% of the profits in addition to his salary as compensation for his investment of service, special ability and personal goodwill, if any. This would certainly be a legal arrangement and the bonus together with the salary an allowable deduction in determining the profits in which the government and the firm were entitled to share pro rata.

There of course could be no objection to the firm and the manager making a specific contract whereby income tax was to be considered in determining the bonus, in fact the necessity of being specific is recognized by Prentice-Hall on the same or subsequent page previously referred to where there is submitted a proposed specific clause to be inserted in a contract so as to cover this point. Now, it seems logical to me to take the position that if in order to remove question it is necessary to insert a clause in the contract, in the absence of such a clause the tax can certainly not be deducted under the wording of your problem in determining the bonus.

It also seems to me that unless a specific arrangement has been made, numerous exceptions might arise and be taken to any plan of apportioning the tax to the various departments. For example, the various percentages of gross and net profit, relative expenses, etc., as between departments. Furthermore, the plan that you outline results in a double taxation under the income-tax laws for the manager, which is hardly equitable although legal, inasmuch as he stands a part of the taxes assessable against the firm and is also subject to income tax himself disregarding exemptions.

In conclusion I want to state that I believe several of the leading firms of accountants, instead of charging income taxes as accrued or paid before determining net profits, are carrying net profits to surplus account and then charging as a direct item the income taxes against surplus. I know this has been done for several years past by one of the large New York firms, several of whose partners are on the council and committees of the American Institute. This has been in relation to the accounts of a large concern in which I am interested.

Assuring you that the reason for my taking issue with you is in order to get the point satisfactorily settled because I feel, like you, that it is an important one, and thanking you for your promptness in replying to my letter, I remain,

Yours very truly,

CHARLES F. SEEGER.

The paragraph in Montgomery's *Income Tax Procedure, 1918*, page 302, is the following:

"A decision under the British income act illustrates the point that income taxes are not of the nature of expenses:

"A gas company was prohibited by its special act from paying dividends to its shareholders above a fixed rate per annum. The company claimed to deduct the amount of the income tax from its gross profits before paying any dividend and then to pay the dividend in full to the shareholders. Held that the company was not entitled to do so, and that in arriving at the rate of dividend, the profits ought to be calculated as inclusive, and not exclusive, of the amount payable in respect of income tax."

To be quite honest about it, the editor of this department does not know what this decision means. But it does not seem possible that it means a requirement for the corporation to pay a dividend equal to the full amount of the profits before deducting the tax, because if the company started the year with no surplus, the payment of such a dividend would certainly leave it with a deficit at the end of the year.

In quoting from page 301 of the same book by Mr. Montgomery, a very important part of the sentence was omitted. The full quotation is: "If the 50 per cent now set apart as the government's share could be treated as an expense by the taxpayer *and operate to diminish the amount due to the government*, it would produce an illogical result." The words in italic are the words omitted by Mr. Seeger; the italic is the editor's. But the point is that this quotation has reference to the deductibility of federal taxes in determining taxable net income. And it is the contention of the editor that rulings prohibiting the deduction of federal taxes in computing taxable net income do not necessarily apply to the computation of the real net profit of a corporation.

The Prentice-Hall *Federal Tax Service* quotation merely amounts to this: It is desirable to insert a clause in the bonus contract stating definitely what will be done about federal taxes in determining profits subject to the bonus. Mr. Seeger says: "Now, it seems logical to me to take the position that if in order to remove question it is necessary to insert such a clause in the contract, in the absence of such a clause the tax can certainly not be deducted under the wording of your prob-

lem in determining the bonus." That seems to the editor a good deal like begging the question. We must get back to the crux of the problem: either the tax is an expense or a distribution of profits. Now if it is an expense it would be as logical for Mr. Seeger to say that no expense could be deducted unless the contract with the employee mentioned that expense. Hence the statement that "the tax can certainly not be deducted" merely begs the question by assuming that the tax is a distribution of profits.

The editor was not able to obtain a fourth edition of Black's *Income and Other Federal Taxes*, but in the third edition he found a section on gains, profits and income in which much the same idea was expressed as in the sentence quoted. But this section dealt with the subject only from the tax standpoint. In other words, the quotation unquestionably means that all the acts of congress (dealing with income taxes) have associated together the words "gains," "profits" and "income" as descriptive of the subject taxed.

Mr. Seeger insists that the construction which the courts place upon the tax laws in determining net income in disputed tax cases is relevant in determining net income for other purposes. If the rules for determining taxable net income are always the same as the rules for determining corporate profits for other purposes, the discussion is of course closed. But the editor does not believe that this is so. One instance has already been cited. The editor can not believe that a corporation beginning the year with no surplus, making \$40,000.00 profits before taxes, paying \$5,000.00 in taxes, and having \$35,000.00 left, could pay dividends of \$40,000.00 without impairing its capital and incurring all the risks involved in an impairment of capital by the payment of dividends. Now, if the tax law does not apply to the computation of profits for dividend purposes, what reason is there for believing that it applies to the computation of profits for any other purpose (except taxes) such, for instance, as the computation of profits subject to a bonus?

Now let us look at the question in another and practical light. It is probably safe to say that prices are determined in a broad way at least by considering the amount necessary to obtain in order to pay for materials, labor and all other charges and leave a residue for profits. It can hardly be doubted that if all business men suddenly found that their rents were being enormously increased, prices would go up. Similarly, when federal taxes increased, prices went up. But they went up so as to provide a larger margin which could absorb the taxes and leave profits adequate to pay a return on capital. Of course it is not contended that if there were no federal taxes the net profit of corporations would be exactly the same as it is now after the payment of taxes. But there is at least a conscious tendency to raise prices enough to produce a wider margin, so that the deduction and payment of taxes will leave the same net profit as before. The business management knows that this larger margin is required in order to cover the additional charge, which it considers an expense. Is it logical for the employee to contend that this tax is not an expense?

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That this increased margin necessitated by the tax is all profit and insist on a bonus based thereon? Is it not more logical for the employee to recognize that profits *after* deduction of taxes are probably approximately the same as profits would be if there were no federal tax, so that in reality he does not suffer by the deduction of the tax in determining the profits subject to the bonus, but would reap an unjustifiable benefit by taking his bonus on the profits before deducting the tax?

JOINT VENTURES AND PARTNERSHIPS.

It is a well-known principle of law that in the absence of an express agreement to the contrary partners are assumed to have agreed to share profits equally, regardless of their capital investments. A problem in joint-venture profits was submitted to this department and a solution was printed in the July issue. Two letters have been received by the editor maintaining that the assumption as to an equal profit-and-loss division does not apply in joint ventures. These letters contend that in the absence of an express agreement the law assumes that profits will be shared in the capital ratio.

Since receiving these letters the editor has made inquiries among attorneys but has been unable to find one who knows of a different legal assumption as to profit-sharing by participants in a joint venture. The point seems sufficiently important to justify re-printing the problem and solution, together with one of the letters. If the legal assumption as to joint-venture profit-sharing differs from the legal assumption as to partnership profit-sharing, it is hoped that some reader will furnish the editor with citations covering the law, as well as a legal rule for determining when a business is to be considered a partnership and subject to the legal assumption of an equal division of profits, and when it is to be considered a joint venture and subject to some other legal assumption as to the division of profits.

QUESTION.—SUBMITTED BY T. W. B.

A and B purchase an invoice of cotton consisting of 200 bales for which they pay \$20,000.00. Of this amount A contributes \$12,500.00 and B contributes \$7,500.00. Later C offers \$10,000.00 for a one-third interest in this invoice, which A and B accept. You are asked to submit figures on which to base the distribution of this \$10,000.00; so that both A and B will receive absolute justice and that they may all continue equally interested in the venture.

ANSWERS.—SUBMITTED BY T. W. B.

No. 1.

Withdrawal of original investment by A and B:

A—withdrawal	\$12,500.00—\$6,666.67=	\$5,833.33
B—withdrawal	7,500.00— 6,666.67=	833.34

Premium on sale of $\frac{1}{3}$ interest to C:

\$10,000.00—\$6,666.67=	\$3,333.33
A—50% of \$3,333.33	\$1,666.67
B—50% of 3,333.33	1,666.66

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Total distribution of \$10,000.00 paid by C:

	Capital	Premium	Total
A	\$5,833.33	\$1,666.67	\$7,500.00
B	833.34	1,666.66	2,500.00
Total			<u>\$10,000.00</u>

No. 2.

Withdrawal of original investment by A and B:

A—withdrawal (as above)	\$5,833.33
B—withdrawal (as above)	833.34

Premium on sale of $\frac{1}{3}$ interest to C—\$3,333.33 as above.

A— $\frac{5}{8}$ of \$3,333.33	\$2,083.33
B— $\frac{1}{8}$ of 3,333.33	1,250.00

Total distribution of \$10,000.00 paid by C:

	Capital	Premium	Total
A	\$5,833.33	\$2,083.33	\$7,916.66
B	833.34	1,250.00	2,083.34
Total			<u>\$10,000.00</u>

No. 3.

Withdrawal of original investment by A and B:

A—withdrawal (as above)	\$5,833.33
B—withdrawal (as above)	833.34

Premium on sale of $\frac{1}{3}$ interest to C—\$3,333.33 divided 50 cents on each \$1.00 withdrawn.

A—\$5,833.33 x .50	\$2,916.67
B— 833.33 x .50	416.66

Total distribution of \$10,000.00 paid by C:

	Capital	Premium	Total
A	\$5,833.33	\$2,916.67	\$8,750.00
B	833.34	416.66	1,250.00
Total			<u>\$10,000.00</u>

EDITOR'S COMMENTS IN JULY ISSUE.

The above problem, submitted by T. W. B., cannot be solved with any certainty because there is no statement as to the ratio in which profits are to be shared. If profits are shared equally, the first solution is correct. If they are shared in the capital ratio, the second solution is correct. In the absence of an agreement, partnership profits are shared equally; therefore, in the absence of a stated agreement, the first solution must be assumed to be correct. I cannot see that the third solution would be correct in any circumstances.

Editor, Students' Department:

SIR: The problem submitted by T. W. B. is a modification of a famous C. A. problem abroad. The terms of the problem, as submitted, provide that a one-third interest in the venture as started by A and B is sold to C for \$10,000.00, thus leaving A, B and C at one-third interests respectively.

Now the absence of an agreement as to the sharing of partnership profits and losses would be of no effect in this case, since the thing parted with A and B was an interest in their venture—which was to buy and sell,

if possible, a certain parcel of cotton. That is, in contemplation of the law, the premium or bonus paid by C to secure a one-third interest in the venture is not a profit from the venture. The results of the venture remain problematical until the cotton is finally disposed of. Therefore, "so that both A and B will receive absolute justice and that they may all continue equally interested in the venture," the payment of C should be apportioned between A and B on the basis of their original contributions but giving consideration to the one-third interest retained by each of them respectively. For example:

Original capital contributions			Capital interest retained		Share of capital interest contributed by A & B to C
A..	\$12,500.00 ($\frac{5}{8}$)	Deduct	\$6,666.67 ($\frac{1}{3}$)		\$5,833.33 ($\frac{7}{24}$)
B..	7,500.00 ($\frac{3}{8}$)	Deduct	6,666.66 ($\frac{1}{3}$)		833.34 ($\frac{1}{24}$)
	<u>\$20,000.00</u> ($\frac{8}{8}$)		<u>\$13,333.33</u> ($\frac{2}{3}$)		<u>\$6,666.67</u> ($\frac{1}{3}$)

Hence, since the one-third interest purchased by C is contributed $\frac{7}{24}$ (or seven parts) by A, and $\frac{1}{24}$ (or one part) by B, the \$10,000.00 should be apportioned on the same basis, i. e.:

A	$\frac{7}{8}$	\$8,750.00
B	$\frac{1}{8}$	1,250.00
Total		<u>\$10,000.00</u>

The method of adjusting the capital accounts on the books is obvious. This agrees with the results of solution 3, which you totally reject, although the detail there is not stated properly.

Yours truly,

JAMES SYMINGTON.

New York.

To this letter the editor of the *Students' Department* replied:

DEAR SIR: I have your very good-natured criticism of my solution to the joint-venture problem. Incidentally, I received in the same mail another letter taking exactly the same stand which you take.

Still, I cannot agree with you, although I am willing to be convinced. To be convinced, however, I shall have to be shown that the law in regard to distribution of joint-venture profits is different from the law in regard to the distribution of partnership profits. May I ask you two questions?

First, does joint-venture law assume a division of profits in the capital ratio, or in the ratio of capital interests sold, instead of equally as in the case of partnership law?

Second, let us assume that the word partnership had been used instead of joint venture. A and B are in partnership, dealing in cotton. They invested \$12,500.00 and \$7,500.00 respectively, and put it all into cotton. Nothing is said in regard to the sharing of profits. Then the law provides that the profits shall be shared equally. Now, in admitting C by a transfer of \$5,833.33 from A's capital and a transfer of \$833.34 from B's capital, a profit of \$3,333.33 is made. Where is my logic wrong when I take the position that this \$3,333.33 is a profit which the partners take now instead of waiting to take in the future? If A and B had not admitted C, but had waited to take their profits by a sale of the cotton, they would have shared the profit in equal parts, in the absence of an agreement. But they do admit C and he will get some of the ultimate profit which A and B would otherwise have divided equally. Why should they not divide this *nunc pro tunc* profit equally?

If I have made a mistake in this solution I do not want to let it go uncorrected, and I shall appreciate any citations which will demonstrate an error if one exists.

Yours truly,

There are really two points at issue here.

First: Does the law assume that joint-venture profits from operations shall be shared in the capital ratio instead of equally? If so, this is entirely different from the assumption governing partnerships, and it becomes necessary to have well-defined rules by which joint ventures and partnerships can be distinguished.

Second, does one rule govern the distribution of operating profits while another rule governs the distribution of profits arising from the sale of a capital interest?

This second question is important because it will be noted that in the third solution, which Mr. Symington contends is the correct one, the profit on the sale of the capital interest is not divided equally nor in the ratio of the capital investments, but in the ratio of the capital interests sold.

It should be remembered that the correct solution of this problem depends upon law, not upon ideas of fairness. It may be fairer to divide profits in the capital ratio than to divide them equally; the law will protect such an agreement but will not assume that such an agreement was made. And it may be fairer to divide profits from the sale of a capital interest in the ratio of the interests sold than to divide them equally; but if the law makes a distinction between operating profits and realization profits from the sale of a business or a portion thereof, applying one rule to the division of operating profits and another rule to the division of profits from the sale of a capital interest, the editor of this department is not aware of it.

In conclusion, the first solution seems to be correct if the legal assumption of an equal division of profits applies with equal force to joint-venture and partnership profits, and if the division of profits from the sale of a capital interest is governed by the same legal rules as profits from operations.

The second solution is correct if the law requires the division of joint-venture profits (in the absence of an agreement) in the capital ratio, while requiring the division of partnership profits equally.

The third solution is correct if the law makes a distinction between operating profits and profits from the sale of a capital interest, requiring that the profits from the latter source shall be divided in the ratio of the capital interests sold.

DIVISION OF PARTNERSHIP GOODWILL.

The May examination of the American Institute of Accountants contained a problem requiring the computation of the goodwill of a partnership, and the computation of the interest of a retiring partner in this goodwill. The goodwill was to be computed on the basis of the profits of the three years next preceding the partner's retirement.

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During those years the profit-and-loss ratio changed, the profits being divided among the partners in a different ratio each year. In the published solution in the July issue, the editor allowed the retiring partner a portion of the goodwill computed by multiplying the total goodwill by the retiring partner's profit-sharing rate for the third year, which was also, of course, the year of his retirement.

Editor, Students' Department:

SIR: Your solution of problem 1, of the American Institute of Accountants' examination in accounting theory and practice, given May 18, 1922, has been carefully studied, and it appears to the writer that the division of the goodwill on the basis of the profit-and-loss ratio for the year in which it is placed upon the books is in error for the following reasons:

First, such division would naturally infer that the goodwill was earned in that year. The mere fact that the goodwill earned by the partnership was not placed on the books until the end of the third year would in no way set aside the fact that it was earned in the previous years, as well as the current year. While it might be contended that it was earned in the third year by reason of its realization, yet the fact remains that the goodwill was actually earned during the life of the partnership.

Second, accepting the reasoning as above, it would be apparent that an injustice would be wrought on the partners by dividing it on the basis of the profit-and-loss ratio of the third year.

The writer has failed to find this condition covered in the accounting works he has available and would appreciate an authority for dividing such goodwill.

In the writer's solution it was assumed that the goodwill was earned in the same proportion that the income was earned, and the amount was then divided by taking the profit-and-loss ratio for each year. The examiners passed the writer in this examination, and he is interested in knowing the correct solution.

Thanking you for any information you may be able to furnish, I am

Yours truly,

Pittsburgh, Pa.

R. J. LAVALLEE.

The payment for goodwill is not a payment for past profits; if it were, it would probably be correct to divide the goodwill among the partners in the average profit-and-loss ratio of the past. But the payment for goodwill is a payment for future profits. The retiring partner will not share in these future profits because he will no longer be a partner, but in retiring he is entitled to compensation for his share of the net assets and also for his share in the future profits which will be in excess of a fair return on the capital. He is entitled to compensation for these future excess profits because, presumably, he helped to develop the business to the point where it pays excess profits.

Recourse is had to past profits in computing the goodwill only because these past profits are considered the best available evidence of the probable future profits. But it is future profits which are being paid for when payment is made for goodwill. The retiring partner's share of these future profits will, presumably, be his present profit-and-loss per cent because the profit-and-loss ratio can not be changed

in the future without his consent. That is, if he remained in the partnership, he would share in the future profits in the same ratio that he shared profits during the year preceding his retirement, unless of course he consented to some other ratio. Hence, the distribution of goodwill on the basis of the last year's profit-and-loss ratio is merely an immediate allowance to the retiring partner for future profits, in the ratio in which he would have shared these future profits. A distribution of the goodwill in the average profit-and-loss ratio of the past would not be correct unless there was an intention to share profits in the future in the average ratio of the past instead of in the ratio existing at the time of the dissolution.

PROBLEM IN MANUFACTURING OVERHEAD.

A reader has requested a solution to the following problem:

The Universal Manufacturing Company commenced business January 1, 1921, with a paid-up capital of \$700,000.00. The following is a trial balance of the company at December 31, 1921:

	Debits	Credits
Cash	\$40,000	
Accounts receivable	51,000	
Accounts payable		\$83,000
Notes payable		150,00
Branch current account	143,000	
Plant and equipment	400,000	
Raw materials purchased	600,000	
Productive labor	200,000	
Non-productive labor	50,000	
Manufacturing supplies and expenses	100,000	
Selling expenses	80,000	
Administrative expenses	80,000	
Interest paid	8,000	
Cash discount earned		6,000
Cash discount allowed	12,000	
Sales to customers and branches, 80,000 units at \$10.00 each		800,000
Capital stock		700,000
Reserve for depreciation		25,000
	\$1,764,000	\$1,764,000

The inventories at December 31, 1921, as shown by the books, follow:

Raw materials	\$150,000
Work in process	100,000
Finished goods	150,000

The corporation declared a dividend December 27th of 5% on the capital stock, payable January 2, 1922.

A profit-and-loss statement was submitted to the bank showing net profit of \$76,000.00.

Upon examination the following is found:

The cost records are not controlled by the general books.

The raw materials on hand were valued at cost, the market value of which was \$100,000.00.

The burden taken into cost of production for the year consisted of \$50,000 for indirect labor, \$100,000 for manufacturing supplies and expenses and \$50,000 for interest on investment.

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The work in process was valued as per the cost sheets of the company as follows:

Material	\$21,000
Productive labor	39,500
Burden	39,500
	<u>\$100,000</u>

You are informed by the management that the factory operated 50% of the normal capacity during the year; also that the manufacturing burden as previously stated was the normal burden based on 100% capacity.

The finished units on hand at December 31, 1921, amounted to 20,000 valued at \$150,000 as per cost sheets.

The branch office reports the following:

Cash	\$3,000
Accounts receivable	40,000
Purchases from home office:	
60,000 units at \$10	600,000
Sales: 50,000 units	\$500,000
Home office account	143,000

The units at the branch office at December 31, 1921, amounted to 10,000.

Required: balance-sheet at December 31, 1921; statement showing cost of production and profit and loss.

UNIVERSAL MANUFACTURING COMPANY Statement of Cost of Goods Manufactured Year Ended December 31, 1921

Raw materials:

Purchases	\$600,000.00
Less inventory—December 31, 1921—cost	150,000.00
	<u>450,000.00</u>
Cost of raw materials used	450,000.00
Add market decline in inventory—Dec. 31, 1921:	
Cost	150,000
Market	100,000
	<u>50,000.00</u>

Charge to manufacturing for raw materials .. \$500,000.00

Productive Labor 200,000.00

Manufacturing expense:

Non-productive labor	50,000.00
Manufacturing supplies and expense	100,000.00

Total manufacturing expense—75% of labor .. 150,000.00

Total 850,000.00

Deduct goods in process—December 31, 1921:

Materials (cost \$21,000) market value	14,000.00
Productive labor	39,500.00
Burden: 75% of \$39,500	29,625.00

83,125.00

Cost of manufacture of 100,000 units 766,875.00

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The \$50,000.00 loss due to the decline in the market value of the raw materials, is thrown into the manufacturing cost because this would be the customary effect of valuing the closing inventory at market instead of cost. It would be more logical, however, to include in manufacturing cost only the cost of the materials used and to make the \$50,000.00 decrease in the value of the closing inventory a direct profit-and-loss charge.

UNIVERSAL MANUFACTURING COMPANY

Profit-and-Loss Statement

Year Ended December 31, 1921.

Sales:

At home office—20,000 units at \$10.00	\$200,000.00
At branch office—50,000 units at \$10.00	500,000.00
Total	700,000.00

Deduct cost of sales:

Cost of 100,000 units manufactured	\$766,875.00
Cost of 30,000 units unsold	230,062.50
	536,812.50

<i>Gross profit on sales</i>	163,187.50
Deduct selling expenses	80,000.00

<i>Net profit on sales</i>	83,187.50
Deduct administrative expenses	80,000.00

<i>Net profit on operations</i>	3,187.50
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Deduct net financial expense:

Interest paid	8,000.00
Cash discount allowed	12,000.00
Total	20,000.00
Less cash discount earned	6,000.00
	14,000.00

<i>Net loss for the year</i>	\$10,812.50
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UNIVERSAL MANUFACTURING COMPANY

Balance-sheet, December 31, 1921

ASSETS

Fixed assets:

Plant and equipment	\$400,000.00
Less reserve for depreciation	25,000.00
	\$375,000.00

Current assets:

Inventories:	
Raw material	100,000.00
Goods in process	83,125.00
Finished goods	230,062.50
	413,187.50
Accounts receivable	91,000.00
Cash	43,000.00
	\$922,187.50

Students' Department

LIABILITIES

Current liabilities:

Accounts payable	\$83,000.00	
Notes payable	150,000.00	
Dividends payable	35,000.00	
		\$268,000.00

Capital:

Capital stock	700,000.00	
Less deficit	45,812.50	
		654,187.50
		\$922,187.50

LAWRENCE E. BROWN

Lawrence E. Brown, member of the American Institute of Accountants, died at Philadelphia, October 30, 1922. Mr. Brown was a member of the firm of Lawrence E. Brown & Company. He was a member of the Pennsylvania Institute of Certified Public Accountants and had been in practice in Philadelphia for many years.

W. W. STERRETT

W. W. Sterrett, member of the American Institute of Accountants, died at Devon, Pennsylvania, October 28, 1922. Mr. Sterrett was a certified public accountant of Pennsylvania and a member of the Pennsylvania Institute.

THOMAS E. TURNER

Thomas E. Turner, member of the American Institute of Accountants, died November 15, 1922, at Louisville, Kentucky. Mr. Turner was a member of the firm of Turner, Spencer & Co., and was one of the pioneers of accountancy in Kentucky.

GEORGIA SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

At a meeting of the Georgia Society of Certified Public Accountants, held October 28, 1922, the following officers were elected: President, Joel Hunter; first vice-president, Alonzo Richardson; second vice-president, C. H. Highley; third vice-president, Thos. J. O'Brien; secretary, W. H. James; treasurer, G. N. Spring.

OHIO SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

At the annual meeting of the Ohio Society of Certified Public Accountants the following officers were elected:—L. G. Battelle, president; C. A. Gano, vice-president; W. E. Langdon, secretary and treasurer; and E. A. Roden, W. D. Wall, R. A. Hurst and W. F. Vieh, directors.

Gladstone Cherry and George H. Cheyne announce the formation of a partnership under the firm name of Gladstone Cherry, Cheyne & Company with offices at 818-820 First Wisconsin National Bank building, Milwaukee, Wisconsin.

Emlyn E. Jones and Arnett Potter announce the formation of a partnership under the firm name of Jones & Potter, with offices at 614 Weightman building, Philadelphia.

Terminology Department

CONDUCTED BY THE SPECIAL COMMITTEE ON ACCOUNTING TERMINOLOGY
OF THE AMERICAN INSTITUTE OF ACCOUNTANTS

During the months that the *Terminology Department* has appeared in *The Journal of Accountancy* the committee on terminology has received a number of very fine letters with reference to terminology matters. In some instances the writers have merely disagreed with the language or with the illustrations used by the committee, while in other cases different views were expressed regarding the fundamental meaning of a word. The committee wishes to express publicly its appreciation for all these suggestions and to state that every suggestion has received careful consideration by all members of the committee. It is hoped that other members of the profession will take the opportunity to offer suggestions or to make criticisms, for the committee believes this the best way to obtain sound and acceptable definitions for many of the more commonly used words in accountancy.

In this issue of *The Journal of Accountancy* the committee presents two letters, both with reference to the article appearing in the September issue of the magazine. Each of these letters shows a careful consideration of the subject and a fine spirit on the part of the writer. The letters follow:

LETTER No. 1

"The committee on terminology certainly has a job on its hands in attempting to build up an accepted terminology. I think that at the outset several points should be stressed in accordance with which the committee will do its work. We must realize that the attempt to make our ideas square with the dictionary is hopeless; therefore let us forget the dictionary and settle upon a terminology which will meet the views of the practitioners, and if the members of the institute accept the definitions which have been prepared by its committee, the dictionary makers must follow suit. Moreover, we need not confine our use of a special term to its use in common parlance because our usage should take on an exactness that is often absent in the vernacular.

"Let us take for example the word depreciation. The definition published by the committee first brings out the derivation of the word from the Latin, that is, the idea of a reduction in price or value. Now a reduction in price may be caused by economic conditions and may reflect economic conditions exclusively, but it seems to me that we should not use the word to mean both a reduction in price due to economic conditions and a loss in value due to wear and tear. Then again, when you say reduction in value, do you mean value in exchange or cost value or any other idea of value that we may conjure up. I notice in several places that the committee mentions the fact that regulatory bodies comprehend depreciation to include obsolescence and inadequacy. Should we not at the very outside of our work ignore definitions of regulatory bodies and if regulatory bodies wish to include obsolescence in their terminology of depreciation, we can as accountants take care of the situation in another way by providing if desired, a separate reserve for obsolescence and a separate reserve for depreciation.

"We all know that as a general rule accountants in providing for a reserve for depreciation undertake to determine which is the predominant factor, that is to say, whether wear and tear or obsolescence is the ele-

ment which is most effective in the extinguishment of the asset value and having determined that, the provision for depreciation is arranged for accordingly. I do not believe that we will ever get anywhere on terminology unless we take just such an attitude. We must ignore common usage dictionary makers and the inexact definitions of regulatory bodies and begin our work with the idea of making a definition fit one particular set of circumstances or conditions and no others; otherwise you will be up against as difficult a problem as attempting to define the word bank without any qualifying adjective, and the work of your committee will go for naught as did the well-intentioned efforts of an earlier committee.

"I am suggesting a definition of depreciation as a basis for discussion as follows: 'Depreciation—the measure of the loss in cost value of physical property which is assumed to have occurred in the past and which is not offset by adequate repairs or renewals, caused by wear and tear, disuse or climatic conditions; that proportion of the original cost value which is assumed to have expired and which reflects the deterioration in physical or functional value due to wear and tear, disuse or action of the elements. Provision for depreciation does not contemplate extraordinary catastrophes which are contingencies more or less remote nor does it comprehend a provision for the replacement of the equipment at a later date but at increased cost due to rising price levels. All physical property is subject to deterioration and a provision for depreciation is an estimate intended to cover these elements only. On the retirement of property from service, the scrap value, if any, is ascertained and the difference between the cost value and the scrap value is charged against the surplus profits reserved or set aside to meet this contingency. Any excess of such reserved profits is transferred to surplus. Any deficiency in the amount of reserved profits is charged to surplus or capital accounts.'

"You will note from the above definition that I bring out the idea that depreciation has reference always to cost value; that it is an element of loss which is assumed to have occurred and by the use of the word 'assumed' I overcome the objectionable use of 'theoretical,' and I bring out the idea that it is caused solely by wear and tear, by disuse or climatic conditions. The definition limits depreciation to the elements mentioned above. I avoid the use of the word reserve for depreciation because I think that the committee must ultimately settle the use of the word reserve, and I am not at all in entire agreement with Mr. Finney in his conclusions in this matter as set out in his paper in Chicago.

"I am also giving the following definition of the word fluctuation: 'Fluctuation—the term used to denote the increase or shrinkage in the conversion value of property due solely to economic or related causes such as supply and demand or variation in the value of the medium of exchange. In periods of demand or during rising price levels the cost value of property usually tends to be lower than value in exchange; when articles are in plentiful supply or in periods of falling price levels, cost value usually tends to be greater than exchange value. In any event fluctuation is the difference between cost value and value in exchange at any particular time.'

"I am not entirely certain that this word is the best one to be secured but I believe that we ought to have a separate term which will denote the increase or decrease from cost value to conversion value due solely to economic conditions, such as the operation of the law of supply and demand or the changes in the value of the medium of exchange. This means that depreciation when used in the sense of shrinkage in conversion value and appreciation disappear from terminology.

"With reference to the definition of depletion, I have no objection to the committee's definition as it stands provided, however, that item (B) is eliminated. Here we are carrying over the term used in common parlance, and it would seem to me that we ought to omit to mention it

in our accounting terminology. The next paragraph beginning with the words 'depletion differs' is all right provided that we use the word cost value instead of value and add the words 'or climatic conditions' after the word neglect.

"With reference to the use of the word amortization, I believe that the use of this term should be confined entirely to a condition where the life of the asset is definitely known and where a definite amount can be written off in each fiscal period. This would confine the use of the term to premiums on investments purchased, leaseholds, patents or other intangibles with a definite fixed and determinable life, and physical property purchased for a specific purpose and valueless (except possibly for conversion to other uses) at the expiration of a certain period. The use of the term amortization in connection with physical plant would be proper in the case of the purchase of war facilities.

"I am not at all in sympathy with the use of the term amortization when used in connection with debt. Let us find some other term for the gradual extinguishment of debt.

"I find no fault with the definition of obsolescence or with that of inadequacy.

"I am, of course, open to conviction in the views expressed above and I offer them to the committee for whatever they may be worth. I am sending you two carbon copies of this letter in case you desire to send them to the other members of your committee."

LETTER No. 2

"My general impression is that the committee has used great care to be accurate and to get the gist of the matter in each case. Yet if I had been doing the work I think I should have given a little different emphasis in some instances.

"*Depreciation.* Would it not be a good idea to show that, for accounting purposes, depreciation relates to and is based upon the original outlay? I know some people would say that is only one way of figuring depreciation, but to my mind it is fundamental in depreciation, that when your reserve becomes equal to the cost, there is nothing further to depreciate. The definition seems to concern itself primarily with the physical facts of depreciation; yet when you say that 'depreciation is at best only an estimate' you are of course speaking of the measurement and recording of it. The definition seems to me to leave the matter too much in the hands of the engineers, and to contain too little of the accounting aspect.

"*Amortization.* I wonder if the distinction between depreciation and amortization is definitely shown by the case given. It would be my first reaction that such mine shafting should be depreciated on the basis of a normal life, and that the balance which would be left unrecouped is the amount which would be amortized. That is what, I believe, has been happening on the war plants which have been amortized under income tax regulations. They were depreciated at a more or less normal rate during the life of their original usefulness, and the balance is what was amortized.

"*Appreciation.* In view of the fact that the off-setting of appreciation and depreciation is usually done wrongly, I think it would greatly strengthen the statement if it read 'appreciation is the antonym of depreciation *only* in so far as the latter is used to denote shrinkage in conversion value.'

"*Obsolescence.* I am a bit taken aback to learn that obsolescence is a mere segregation of surplus. I think it would at least depend on circumstances. How about the electrical industry, where I understand that most of the equipment is retired from obsolescence, rather than from wearing out? Would it be contended that the process of recovering the original outlay is *not* a cost? The expression 'obsolescence rarely accrues'

again seems to refer to the physical facts of the plant. If 'accrual' means simply the apportionment of incomes and outlays over the period of their operation of life, then it would seem that obsolescence accrues in the same way as depreciation. The whole question seems to turn on whether a machine is a *cost* of the products coming from it in its lifetime. If its lifetime is cut short by something entirely outside the influences of the industry then I would admit that its loss is not a cost. A machine destroyed by fire or flood is not a cost; if it is properly insured outside no loss arises; if it is not, then surplus may be the only cover for it. But if the life of the asset is curtailed by factors operating within the conditions of the industry, whether it be from wearing out, or from the progress of the arts and invention, it would seem to me that the whole of the original outlay is a charge to the period of its life. I believe that is good economics as well as good accounting: each industry must carry its own costs, including the costs of its own progress.

"You will see from the foregoing that it raises quite important questions in my mind. If I were to discuss the points with you, as you doubtless have with other members of the committee, I might shift my ground. I simply give my present reactions.

"I shall be interested to watch progress."

Additional discussion of the original article appearing in the September issue or of the letters appearing in this issue of *The Journal of Accountancy* is invited. Communications should be addressed to any one of the undersigned.

WALTER MUCKLOW, *Chairman*,
420 Hill Building,
Jacksonville, Florida

EDWARD H. MOERAN,
120 Broadway, New York

J. HUGH JACKSON,
56 Pine Street, New York

Edward R. Burt & Company announce the removal of their offices from the Balboa building to 731-732 Hearst building, San Francisco, California.

Barrow, Wade, Guthrie & Co., announce that E. D. Hilton is now in charge of their Chicago office.

T. Coleman Andrews announces the opening of an office in American National Bank building, Richmond, Virginia.

Oswald Lyon announces the opening of offices at 40 Court street, Boston, Massachusetts.

Meyer Kurz announces the opening of offices at 25 West 43rd street, New York.

Current Literature

Compiled in the Library of the American Institute of Accountants

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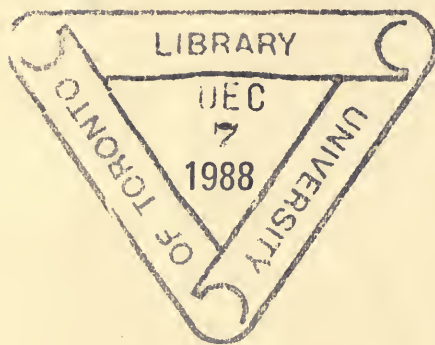
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Montgomery, R. H. *Why Should We Have a New Federal Tax Law?* JOURNAL OF ACCOUNTANCY, November, 1922, p. 334-45.

TURNOVER

McNair, Malcolm P. *Significance of Stock-Turn in Retail and Wholesale Merchandise.* HARVARD BUSINESS REVIEW, October, 1922, p. 87-96.

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